Q2

2013

# QUARTERLY REPORT

**QUESTERRE ENERGY CORPORATION**

2013

QUESTERRE ENERGY CORPORATION IS LEVERAGING ITS EXPERTISE GAINED THROUGH EARLY EXPOSURE TO SHALE AND OTHER NON-CONVENTIONAL RESERVOIRS.

THE COMPANY HAS BASE PRODUCTION AND RESERVES IN THE TIGHT OIL BAKKEN/TORQUAY OF SOUTHEAST SASKATCHEWAN.

IT IS BRINGING ON PRODUCTION FROM ITS LANDS IN THE HEART OF THE HIGH-LIQUIDS MONTNEY SHALE FAIRWAY.

IT IS A LEADER ON SOCIAL LICENSE TO OPERATE ISSUES FOR ITS GIANT UTICA SHALE GAS DISCOVERY IN QUEBEC.

IN CONJUNCTION WITH A SUPERMAJOR, IT IS AT THE LEADING EDGE OF COMMERCIALIZING A PROVEN PROCESS TO UNLOCK THE MASSIVE RESOURCE POTENTIAL OF OIL SHALE.

QUESTERRE IS A BELIEVER THAT THE FUTURE SUCCESS OF THE OIL AND GAS INDUSTRY DEPENDS ON A BALANCE OF ECONOMICS, ENVIRONMENT AND SOCIETY. WE ARE COMMITTED TO BEING TRANSPARENT AND ARE RESPECTFUL THAT THE PUBLIC MUST BE PART OF MAKING THE IMPORTANT CHOICES FOR OUR ENERGY FUTURE.

QUESTERRE'S COMMON SHARES TRADE ON THE TORONTO STOCK EXCHANGE AND OSLO STOCK EXCHANGE UNDER THE SYMBOL QEC.

Our investment to build Kakwa-Resthaven into a new core area was endorsed by the results of the independent Montney resource assessment.

We believe our acreage lies in the sweet spot of the play or the '4% of the acreage' that will be the most economic. Initial wells at the early part of the learning curve are already delivering promising results. There is a clear line of sight to exceptional results in this area.

We plan to further derisk our land by participating in up to three additional joint venture wells in the second half of 2013. The first of these wells will be cored to provide critical data on rock properties. All three wells will be essential to advancing the learning curve.

We are also finalizing our strategy to develop our acreage in this condensate-rich resource. Market access is proving to be a critical path issue. Questerre has been in negotiations with third party processing and pipeline companies to provide both the capital and necessary infrastructure to establish this access. This is a cornerstone of our financing plan to ramp up production.

## Highlights

- Liquids-rich Montney resource independently assessed at 130 million barrels of oil equivalent with over 40% condensate
- Concluded fishing operations on 15-01 well at Kakwa-Resthaven with damage to the formation
- Spring breakup suspended operations and shut-in production in Saskatchewan and Manitoba
- Increased financial flexibility with $26.5 million credit facility with a Canadian chartered bank
- Cash flow from operations of approximately $3 million for the quarter with average daily production of 820 boe/d

## Kakwa-Resthaven, Alberta

With over 40% condensate and over 130 million boe, the McDaniel assessment confirmed the significant scale and value of the dense resource we have acquired in the last year.

The performance of our first three wells is consistent with the condensate assigned to the two evaluated Montney intervals. In its first seven months of production, wellhead condensate from our first well has averaged 140 bbls/MMcf. Our second and third wells have averaged 190 bbls/MMcf and 160 bbls/MMcf during the quarter.

Although our first three wells have only been completed in the middle interval of the Montney, offsetting industry wells have been completed in the upper interval with similar results. Early in the third quarter, our partners announced test rates of over 100 bbls/MMcf of condensate from the upper Montney interval in their well less than one mile away from our joint venture acreage. It is these relatively high condensate rates that contribute to the robust economics and a net present value, discounted at 10%, of approximately $9 per boe in the ground.

While condensate rates per MMcf have remained strong, our overall production continues to be impacted by a lack of field compression and liquids lifting. We are hopeful this will be partially resolved by year-end with the construction of a central compression and condensate stabilization facility with a capacity of 15 MMcf/d plus associated liquids.

These facilities and other upgrades fit our short terms plans for the joint venture acreage. These include drilling additional wells to derisk this acreage. The joint venture has contracted one rig and we expect to keep this busy for the next year. More importantly, we intend to use these new wells to move our way up the learning curve of optimizing drilling and completion design to maximize recovery. During the early production phase, we are largely relying on interruptible access for processing, transportation and marketing.

Our plans for the medium term are to scale up to full field development. A key component is access to infrastructure and liquids markets.

The infrastructure strategy is to secure access to all aspects of the value chain – processing facilities for the natural gas and associated liquids, pipelines to transport the gas to market and NGL mix to fractionators that produce spec product, fractionating and marketing arrangements for all products. We are in discussions with several midstream companies and are hopeful to conclude agreements before year-end.

Full field development will initially focus on our acreage in north Kakwa where we have the potential for almost 190 gross wells (90 net) based on eight wells per section. In the south, we are awaiting the results from our 15-01 well that was damaged by the fishing operations after the control of well incident. Based on these results, we will evaluate additional drilling to retain up to three sections which expire later this year. With the exception of this near term expiry, our remaining acreage is held and we have no other commitments for the next three to four years.

### Antler, Saskatchewan

We will drill two wells this year to expand our oil pool south of the main pool in the Antler area.

The locations were identified on the 3-D survey we shot this winter. If successful, there are up to 20 other locations that could be drilled. We will modify drilling and completion techniques for these wells based on analysis of the best offsetting producers. Wet weather remains a challenge as we are working to drill, complete and tie-in these wells by the end of the third quarter.

Expanding our pilot waterflood at the main pool was also delayed by wet weather and spring breakup. Three additional producing wells are scheduled to be converted into injectors as soon as ground conditions improve. This takes our pilot from the existing one half section to one and half sections. We have another three and a half sections, or five sections in total that have the optimal well configuration for a waterflood.

The economics of the waterflood are compelling. The net cost for conversions is about $0.5 million net per section with the potential to increase recovery by 250,000 to 500,000 barrels per section. We have a further 4-6 sections that, with additional wells, could also be waterflooded.

## Oil Shale Mining

We have been pleased with the progress made by Red Leaf since we made our original investment over a year ago.

Together with Total S.A., Red Leaf is finalizing the engineering and design of the commercial scale capsule. We have been working closely with the Red Leaf technical team and have recently seconded our VP Engineering to this project half time. The key contract for engineering, procurement and construction management is being concluded and field work is scheduled to begin late this fall.

As we look forward to the results from the first large scale capsule, we have been assessing our acreage at Pasquia Hills, Saskatchewan, for its oil shale potential. With the data from our second core program analyzed, we expect results shortly.

We are expecting average yields of between 10-15 gallons/ton as compared to yields of 18-22 gallons/ton in Utah and Wyoming, which are among the richest surface minable shales in North America. Although the shale at Pasquia Hills is not as rich, our large land position of over 39,000 acres, easily accessible infrastructure and royalties of 1% (compared to 12% in Wyoming), could materially improve the economics of development.

## Operational & Financial

Consistent with the first quarter, early production from the Kakwa-Resthaven area improved our results over the last year. The Company's first two wells in the area contributed to average daily production of 820 boe/d up from 525 boe/d in the second quarter of last year. Production in 2012 was also affected by the shuts-ins in Antler of both single well batteries and the main battery due to municipal road bans that were strictly enforced during spring breakup.

The increased production volumes also benefitted from the narrowing differential between the benchmark WTI and Edmonton Light prices. The differential reduced from US$8.10/bbl in the second quarter of 2012 and US$4.79/bbl in the first quarter of 2013 to US$1.59/bbl in the second quarter. Coupled with lower operating costs in the quarter, we generated cash flow of $2.96 million for the quarter and $6.61 million for the first six months of 2013 (2012: $4.51 million).

Capital expenditures in the quarter were $3.85 million. Almost the entire amount related to the fishing costs associate with the 15-01 well and the tie-in of the third non-operated well at Kakwa. We plan to invest an additional $18 million over the remainder of this year, primarily split two thirds and one third between Kakwa and Antler.

## Outlook

We are committed to building our light oil assets as a potential source of internally generate capital for full field development at Kakwa. In the interim, we are well positioned to fund our share of the joint venture program through existing cash, cash flow and the credit facility.

As we prove up the value of our Montney asset, we are also making progress on our high impact projects, including the shale gas discovery in Quebec.

Acceptance of oil and gas development in Quebec appears to be changing for the better. The government recently introduced legislation that would permit hydraulic fracturing. Currently, the focus is for oil projects. However, the recent announcement by TransCanada Pipelines to convert existing pipelines from gas to oil highlights the importance of the Utica as a local supply of natural gas for Quebec.

We have seen the debate shift in Quebec from if development should happen to how it could happen in small part due to the efforts of our communications team. We also helped organize the second annual tour of Alberta farms by Quebec farmers this summer and were pleased with the results. We are looking forward to the report this fall from the oversight committee for the strategic environmental assessment on shale gas development.

While Quebec remains an important asset for Questerre we are pleased with the new assets we have created over the last year and a half.

Michael Binnion
*President and Chief Executive Officer*

Management's Discussion and Analysis ("MD&A") was prepared as of August 14, 2013. This interim MD&A should be read in conjunction with the unaudited condensed consolidated interim financial statements of Questerre Energy Corporation ("Questerre" or the "Company") as at June 30, 2013 and for the three and six month periods ended June 30, 2013 and 2012, and the 2012 MD&A and audited annual consolidated financial statements of the Company for the year ended December 31, 2012. Additional information relating to Questerre, including Questerre's Annual Information Form for the year ended December 31, 2012 is available on SEDAR at www.sedar.com.

Questerre is an independent energy company focused on non-conventional oil and gas resources. The Company is currently developing a portfolio of oil shale assets in North America. It is securing a social license to commercialize its Utica natural gas discovery in Quebec. The Company is underpinned by light oil and other conventional assets. Questerre is committed to the economic development of its resources in an environmentally conscious and socially responsible manner.

The Company's common shares are listed on the Toronto Stock Exchange and Oslo Stock Exchange under the symbol "QEC".

## Basis of Presentation

Questerre presents figures in the MD&A using accounting policies within the framework of International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board.

All financial information is reported in Canadian dollars, unless otherwise noted. Certain amounts in prior years have been reclassified to conform to the current year's presentation.

## Forward Looking Statements

Certain statements contained within this MD&A constitute forward-looking statements. These statements relate to future events or Questerre's future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "budget", "plan", "continue", "estimate", "expect", "forecast", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. We believe the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this MD&A should not be unduly relied upon. These statements speak only as of the date of this MD&A.

This MD&A contains forward-looking statements pertaining to the following:

- the performance of the Company's oil and natural gas properties;
- the size of the Company's oil, natural gas liquids and natural gas reserves and production levels;
- estimates of future cash flow;
- projections of prices and costs;
- drilling plans and timing of drilling, completion and tie-in of wells by Questerre and its partners;
- weighting of production between different commodities;

- commodity prices, foreign exchange rates and interest rates;
- expected levels of royalty rates, operating costs, general and administrative costs, costs of services and other costs and expenses;
- capital expenditure programs and other expenditures and the timing and method of financing thereof;
- supply of and demand for oil, natural gas liquids and natural gas;
- expectations regarding Questerre's ability to raise capital and to continually add to reserves through acquisitions and development;
- the Company's ability to grow or sustain production and reserves through prudent management;
- the emergence of accretive growth opportunities and continued access to capital markets;
- the Company's future operating and financial results;
- schedules and timing of certain projects and Questerre's strategy for future growth; and
- treatment under existing and future governmental and other regulatory regimes and tax, environmental and other laws.

In particular, this MD&A contains the following forward-looking statements pertaining to the following:

- production volumes;
- timing of drilling programs and resulting cash flows;
- future oil and natural gas prices;
- the Company's planned testing and anticipated test results of its 15-01 well;
- the size of our oil, natural gas liquids and natural gas resource;
- future development, exploration and acquisition activities, and related expenditures; and
- future liquidity and financial capacity.

With respect to forward-looking statements contained in this MD&A we have made assumptions regarding, among other things:

- future oil, natural gas liquids and natural gas prices;
- the continued availability of capital, undeveloped lands and skilled personnel;
- the costs of expanding the Company's property holdings;
- the ability to obtain equipment in a timely manner to carry out exploration, development and exploitation activities;
- the ability to obtain financing on acceptable terms;
- the ability to add production and reserves through exploration, development and exploitation activities; and
- the continuation of the current tax and regulatory regimes.

Actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors set forth below and elsewhere in this MD&A:

- volatility in market prices for oil, natural gas liquids and natural gas;
- counterparty credit risk;
- access to capital;
- changes or fluctuations in oil, natural gas liquids and natural gas production levels;
- liabilities inherent in oil and natural gas operations;
- adverse regulatory rulings, orders and decisions;

- attracting, retaining and motivating skilled personnel;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for, among other things, capital, acquisitions of reserves, undeveloped lands and services;
- incorrect assessments of the value of acquisitions and targeted exploration and development assets;
- fluctuations in foreign exchange or interest rates;
- stock market volatility, market valuations and the market value of the securities of Questerre;
- failure to realize the anticipated benefits of acquisitions;
- actions by governmental or regulatory authorities including changes in royalty structures and programs, and income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry;
- limitations on insurance;
- changes in environmental or other legislation applicable to the Company's operations, and its ability to comply with current and future environmental and other laws; and
- geological, technical, drilling and processing problems, and other difficulties in producing oil, natural gas liquids and natural gas reserves.

Statements relating to "reserves" or "resources" are by their nature deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described can be profitably produced in the future.

Readers are cautioned that the foregoing lists of factors are not exhaustive. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement. We do not undertake any obligation to publicly update or revise any forward-looking statements except as required by applicable securities law.

## BOE Conversions

Barrel of oil equivalent ("boe") and billion cubic feet equivalent ("Bcfe") amounts may be misleading, particularly if used in isolation. A boe conversion ratio has been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil and the conversion ratio of one barrel to six thousand cubic feet is based on an energy equivalent conversion method application at the burner tip and does not necessarily represent an economic value equivalent at the wellhead. Given that the value ratio based on the current price of crude oil as compared to natural gas is significantly different from the energy equivalent of six to one, utilizing a conversion on a six to one basis may be misleading as an indication of value.

## Additional IFRS and Non-IFRS Measures

This document contains the term "cash flow from operations", which is an additional IFRS measure. The Company uses this measure to help evaluate its performance.

As an indicator of Questerre's performance, cash flow from operations should not be considered as an alternative to, or more meaningful than, net cash from operating activities as determined in accordance with IFRS. Questerre's determination of cash flow from operations may not be comparable to that reported by other companies. Questerre considers cash flow from operations to be a key measure as it demonstrates the Company's ability to generate the cash necessary to fund operations and support activities related to its major assets.

*Cash Flow from Operations Reconciliation*

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Net cash from operating activities | $ 3,867,319 | $ 3,538,782 | $ 7,572,922 | $ 4,279,582 |
| Change in non-cash operating working capital | (905,254) | (2,318,009) | (961,851) | 232,345 |
| Cash flow from operations | $ 2,962,065 | $ 1,220,773 | $ 6,611,071 | $ 4,511,927 |

This document also contains the terms "netbacks" and "working capital surplus", which are non-IFRS measures.

The Company considers netbacks to be a key measure as it demonstrates its profitability relative to current commodity prices. Operating netbacks per boe equal total petroleum and natural gas sales per boe adjusted for royalties per boe and direct operating expenses per boe.

The Company also uses the term "working capital surplus". Working capital surplus, as presented, does not have any standardized meaning prescribed by IFRS and may not be comparable with the calculation of similar measures for other entities. Working capital surplus, as used by the Company, is calculated as current assets less current liabilities excluding the current portions of the share based compensation liability and risk management contracts.

## Select Information

| As at/for the period ended June 30, | Three months ended 2013 | 2012 | Six months ended 2013 | 2012 |
|---|---|---|---|---|
| **Financial ($, except common shares outstanding)** | | | | |
| Petroleum and Natural Gas Sales | 5,584,673 | 3,444,473 | 12,025,586 | 8,767,631 |
| Cash Flow from Operations | 2,962,065 | 1,220,773 | 6,611,071 | 4,511,927 |
| Per share - Basic | 0.01 | 0.01 | 0.03 | 0.02 |
| Per share - Diluted | 0.01 | 0.01 | 0.03 | 0.02 |
| Net Profit (Loss) | (677,981) | 130,555 | (2,247,046) | (1,702,731) |
| Per share - Basic | - | - | (0.01) | (0.01) |
| Per share - Diluted | - | - | (0.01) | (0.01) |
| Capital Expenditures, net of acquisitions and dispositions | 3,798,229 | 5,188,353 | 29,759,083 | 19,980,026 |
| Working Capital Surplus | 10,608,203 | 47,350,400 | 10,608,203 | 47,350,400 |
| Total Assets | 246,660,044 | 256,759,200 | 246,660,044 | 256,759,200 |
| Shareholders' Equity | 221,695,564 | 233,859,513 | 221,695,564 | 233,859,513 |
| Common Shares Outstanding | 235,297,538 | 230,554,204 | 235,297,538 | 230,554,204 |
| Weighted average - basic | 235,239,846 | 230,945,633 | 234,083,413 | 231,029,836 |
| Weighted average - diluted | 235,546,412 | 232,955,303 | 234,829,930 | 232,728,584 |
| **Operations (units as noted)** | | | | |
| Average Production | | | | |
| Crude Oil and Natural Gas Liquids (bbl/d) | 602 | 441 | 689 | 529 |
| Natural Gas (Mcf/d) | 1,310 | 502 | 1,321 | 574 |
| Total (boe/d) | 820 | 525 | 909 | 625 |
| Average Sales Price | | | | |
| Crude Oil and Natural Gas Liquids ($/bbl) | 92.81 | 83.40 | 88.99 | 88.53 |
| Natural Gas ($/Mcf) | 4.21 | 2.21 | 3.86 | 2.37 |
| Total ($/boe) | 74.84 | 72.10 | 73.05 | 77.08 |
| Netback ($/boe) | | | | |
| Petroleum and Natural Gas Sales | 74.84 | 72.10 | 73.05 | 77.08 |
| Royalties Expense | (7.41) | (6.06) | (6.33) | (4.85) |
| Percentage | 10% | 8% | 9% | 6% |
| Direct Operating Expense | (14.22) | (24.23) | (15.45) | (18.01) |
| Operating Netback | 53.22 | 41.81 | 51.27 | 54.22 |
| Wells Drilled | | | | |
| Gross | - | - | 1.00 | 9.00 |
| Net | - | - | 1.00 | 5.63 |

## Highlights

- Liquids-rich Montney resource independently assessed at 130 million barrels of oil equivalent with over 40% condensate
- Concluded fishing operations on 15-01 well at Kakwa-Resthaven with damage to the formation
- Spring breakup suspended operations and shut-in production in Saskatchewan and Manitoba
- Increased financial flexibility with $26.5 million credit facility with a Canadian chartered bank
- Cash flow from operations of approximately $3 million for the quarter with average daily production of 820 boe/d

## Second Quarter 2013 Activities

*Western Canada*

Kakwa-Resthaven, Alberta

During the second quarter, Questerre commissioned an independent assessment of its Montney resources.

The assessment was conducted by McDaniel & Associates Consultants Ltd. (“McDaniel”), and evaluated the resources associated with the in place petroleum and natural gas on 12,800 net acres or less than half of the Company’s 28,800 net acres in the area.

The assessment included detailed geological and petrophysical analysis of Questerre and adjacent industry Montney wells. It focused on the Upper and Middle Montney intervals. McDaniel assumed a Montney development plan based on an average of eight wells per section (Four wells for each of the Upper and Middle Montney intervals). Total Petroleum Initially In Place on average was estimated at approximately 60 Bcf per section with recovery factors estimated to range from 20% to 55% with a best estimate of approximately 40%.

The report estimates prospective resources net to Questerre to range between a low of 291 Bcfe (49 MMboe) and a high of 774 Bcfe (129 MMboe) with a best estimate of 598 Bcfe (100 MMboe) that includes over 40% condensate. There is no certainty that any portion of the prospective resources will be discovered. If discovered, there is no certainty that it will be commercially viable to produce any portion of the resources.

In addition, economic contingent resources (“ECR”), attributed to only 15% of the Company’s 28,800 net acres, have been assigned a best estimate of 190 Bcfe (32 MMboe) with a range from a low of 95 Bcfe (16 MMboe) to a high of 245 Bcfe (41 MMboe). Approximately 50% of this best estimate or 16 million barrels of oil equivalent are natural gas liquids with condensate accounting for over 83% of this amount. Using their April 2013 price forecast, McDaniel’s best estimate of ECR has a net present value discounted at 10% before tax of $267 million.

Questerre also completed fishing operations on the 15-01 well in the second quarter.

The operations were designed to remove the damaged production casing and other downhole equipment from the control of well incident that occurred during the testing in January 2013. During this initial test of the Montney formation, equipment failure resulted in an uncontrolled release of completion fluids and gas for approximately 48 hours.

Early cleanup and flowback in May took longer than expected due to the heavy weight fluids and viscous plugs used to maintain pressure during operations. These viscous plugs have damaged the formation. Subsequent testing in the third quarter indicates that the plugs are preventing contribution from the formation. Testing may resume later this fall once a chemical program has been developed to remediate the well.

The costs of the blowout and subsequent fishing operations are estimated at approximately $12.5 million. The Company's insurance underwriters have confirmed coverage for over 80% of this amount. An environmental impact assessment on this incident estimates that the impacts to the lease and the surrounding area are minimal.

For the remainder of the year, the Company's activities in this area will concentrate on securing access to infrastructure necessary to process, transport and fractionate its natural gas liquids. In addition, the Company plans to participate in the drilling of up to three (0.75) net wells in second half of 2013 with its partners to develop their joint venture acreage.

<u>Antler, Saskatchewan & Pierson, Manitoba</u>

During spring breakup in the second quarter, approximately 20% or 100 boe/d of the Company's production in these areas was shut-in due to limited road access. Over half of these volumes were at Antler where breakup also suspended the planned expansion of the pilot waterflood for the main pool.

The planned expansion, to be completed in the third quarter of 2013, will include the conversion of three additional producing horizontal wells to water injector wells. This follows the positive results from the first horizontal that was converted to an injector late in the third quarter of 2012. In advance of these conversions, additional surface facilities, including filtration equipment, was installed early in the third quarter.

The Company also completed the processing and interpretation of a recently acquired 3-D seismic survey over its producing acreage in south Antler, approximately 18 miles south of the main pool. The survey identified a number of infill and step-out locations. Two of these locations will be drilled in the third quarter. In addition to completing these two new wells, Questerre plans to complete two existing horizontal wells.

*Oil Shale Mining*

Red Leaf Resources Inc. ("Red Leaf") continued its work with a US affiliate of the French-based supermajor, Total S.A. ("Total"), to jointly develop their oil shale assets in Utah.

Red Leaf is a private Utah-based oil shale and technology company. Its principal assets are its proprietary EcoShale In-Capsule process to recover oil from shale in addition to oil shale leases in the states of Utah and Wyoming. Questerre currently holds approximately 6% of the equity capital of Red Leaf. It has partnered with Red Leaf to develop its oil shale acreage in the state of Wyoming and has an option to obtain licenses to utilize the Red Leaf process.

In 2012, the Red Leaf and Total joint venture began an Early Production System ("EPS") phase to prove the technical and environmental attributes of the process at large scale in Utah. It follows a successful field pilot that was completed in 2009. Total will fund an 80% share of the EPS expenses estimated at US$200 million. Red Leaf and Total subsequently plan to launch an advanced commercial pilot on their jointly held acreage for oil shale in Utah. Total will also fund an 80% share of the first US$200 million of the commercial production phase of operations.

The joint venture is currently completing the design and engineering for the construction of the first commercial scale capsule. Engineering is also being completed on the associated mining and production facilities with field work scheduled to begin in the fall of this year. Concurrently, the joint venture is finalizing contractor selection for the engineering, procurement, construction and management contract for the EPS project.

Analysis of data from the second core hole program on its oil shale acreage at Pasquia Hills, Saskatchewan was completed in the quarter. Results are expected in the third quarter of 2013.

*Corporate*

The Company secured a $26.5 million credit facility with a Canadian chartered bank. Structured as a revolving operating demand loan, any borrowing under the facility, with the exception of Letters of Credit, bears interest at the bank's prime interest rate and an applicable basis point margin based on the ratio of debt to cash flow measured quarterly. The facility is secured by a revolving credit agreement, a $50 million debenture with a first floating charge over all assets of the Company and a general assignment of books debts.

## Production

| *Three months ended June 30,* | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Oil and Liquids (bbl/d) | Natural Gas (Mcf/d) | Equivalent (boe/d) | Oil and Liquids (bbl/d) | Natural Gas (Mcf/d) | Equivalent (boe/d) |
| Saskatchewan | 391 | - | 391 | 419 | - | 419 |
| Alberta | 194 | 1,208 | 395 | 22 | 502 | 106 |
| Manitoba | 17 | - | 17 | - | - | - |
| British Columbia | - | 102 | 17 | - | - | - |
| | 602 | 1,310 | 820 | 441 | 502 | 525 |

| *Six months ended June 30,* | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Oil and Liquids (bbl/d) | Natural Gas (Mcf/d) | Equivalent (boe/d) | Oil and Liquids (bbl/d) | Natural Gas (Mcf/d) | Equivalent (boe/d) |
| Saskatchewan | 428 | - | 428 | 496 | - | 496 |
| Alberta | 216 | 1,208 | 417 | 33 | 526 | 121 |
| Manitoba | 45 | - | 45 | - | - | - |
| British Columbia | - | 113 | 19 | - | 48 | 8 |
| | 689 | 1,321 | 909 | 529 | 574 | 625 |

Daily production in the second quarter of 2013 was impacted by spring breakup in Saskatchewan and Manitoba and production capacity constraints in the Kakwa-Resthaven area.

For the quarter ended June 30, 2013, daily production averaged 820 boe/d as compared to 1,000 boe/d in the first quarter of 2013 and 525 boe/d for the same period in 2012. On a year to date basis, production averaged 909 boe/d as compared to 625 boe/d in 2012.

With increasing natural gas production from the Montney in Alberta, oil and liquids represented 73% of total volumes in the second quarter of this year, down from 78% in the first quarter and 84% in the second quarter of 2012. In addition, oil volumes were lower in the quarter due to production shut-ins of single well batteries in Saskatchewan and Manitoba during spring breakup. In the prior year, inclement weather and the stringent enforcement of road bans shut in production from single well batteries and severely restricted trucking of produced volumes from the main battery to the sales terminal in Antler.

These production shut-ins have continued into the third quarter. Notwithstanding, Questerre expects to increase production from these areas in the fourth quarter of this year with the drilling and completion of two wells, the completion of two existing wells at Antler and the drilling of up to five (1.75 net) wells in Manitoba.

Access to third party processing capacity for natural gas liquids continues to constrain production growth in the Kakwa-Resthaven area. Furthermore, Questerre expects that central compression and additional wellhead equipment will be necessary to lower line pressure and address the high condensate yields respectively. Wellhead condensate rates for the Company's first three wells that are on production have ranged between 140 bbls/MMcf to 190 bbls/MMcf.

To this end, the operator announced its plans to construct a central compression and condensate stabilization facility. The facility will have a capacity of 15 MMcf/d plus associated liquids and is scheduled to be onstream before year-end. This facility will also process natural gas and liquids expected from the three (0.75 net) additional Montney wells planned for the remainder of this year.

## Second Quarter 2013 Financial Results

### *Petroleum and Natural Gas Sales*

| *Three months ended June 30,* | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Oil and Liquids | Natural Gas | Total | Oil and Liquids | Natural Gas | Total |
| Saskatchewan | $ 3,334,498 | $ - | $ 3,334,498 | $ 3,178,655 | $ - | $ 3,178,655 |
| Alberta | 1,609,925 | 469,218 | 2,079,143 | 162,745 | 102,287 | 265,032 |
| Manitoba | 136,164 | - | 136,164 | - | - | - |
| British Columbia | - | 34,868 | 34,868 | - | 786 | 786 |
| | $ 5,080,587 | $ 504,086 | $ 5,584,673 | $ 3,341,400 | $ 103,073 | $ 3,444,473 |

| *Six months ended June 30,* | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Oil and Liquids | Natural Gas | Total | Oil and Liquids | Natural Gas | Total |
| Saskatchewan | $ 7,055,882 | $ - | $ 7,055,882 | $ 8,003,924 | $ - | $ 8,003,924 |
| Alberta | 3,348,547 | 857,986 | 4,206,533 | 511,569 | 231,166 | 742,735 |
| Manitoba | 693,209 | - | 693,209 | - | - | - |
| British Columbia | - | 69,962 | 69,962 | - | 20,972 | 20,972 |
| | $ 11,097,638 | $ 927,948 | $ 12,025,586 | $ 8,515,493 | $ 252,138 | $ 8,767,631 |

Relative to the second quarter of 2012, revenue in the current quarter reflected the higher oil and liquids volumes from Alberta and higher prices. Revenue increased to $5.58 million from $3.44 million in the prior year. Approximately 20% of this increase was due to higher natural gas production which also benefitted from higher natural gas prices.

*Pricing*

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Benchmark prices: | | | | |
| Natural Gas - AECO, daily spot ($/Mcf) | 3.54 | 1.89 | 3.37 | 2.02 |
| Crude Oil - Edmonton light ($/bbl) | 92.55 | 83.95 | 90.36 | 88.09 |
| Realized prices: | | | | |
| Natural Gas ($/Mcf) | 4.21 | 2.21 | 3.86 | 2.37 |
| Crude Oil and Natural Gas Liquids ($/bbl) | 92.81 | 83.40 | 88.99 | 88.53 |

Crude oil prices improved marginally over the second quarter of 2012 with the benchmark WTI averaging US$94.22/bbl in 2013 as compared to US$93.49/bbl in 2012. The Edmonton Light price increased more materially averaging $92.55/bbl in 2013 as compared to $83.95/bbl in 2012. This was due to the differential between these two benchmarks narrowing from US$8.10/bbl in 2012 to US$1.59/bbl in 2013.

Increasing volumes of oil transported by rail and, to a lesser extent, additional pipeline capacity and refineries restarting in the second quarter contributed to the reduction in the differential over the last year. While this differential has decreased significantly over the prior year, Questerre believes it will remain fairly volatile for the remainder of this year.

Questerre's realized prices closely mirror the Edmonton Light price and this narrowing differential. Moreover, the condensate production from the Kakwa-Resthaven area receives a premium to this price. For the second quarter of 2013, Questerre realized a price of $92.81/bbl (2012: $83.40/bbl) for its oil and natural gas liquids as compared to the Edmonton Light price of $92.55/bbl (2012: $83.95/bbl).

Natural gas prices in the second quarter of 2013 were considerably stronger over the prior year. With dry gas production in the US remaining relatively stable, higher residential and commercial weather related demand in the first half of the quarter contributed to the improvement in prices. Prices weakened over the remainder of the quarter with cooler temperatures and reduced power demand over the prior year. For the second half of 2013, weather and demand for power generation as a competitive alternative to coal will remain key determinants of natural gas prices.

Consistent with prior periods, higher heat content natural gas from Alberta contributed to realized prices of $4.21/mcf (2012: $2.21/mcf) in the second quarter as compared to an AECO benchmark price of $3.54/mcf (2012: $1.89/mcf).

*Royalties*

| | | Three months ended June 30, | | | | Six months ended June 30, | | |
|---|---|---|---|---|---|---|---|---|
| | | 2013 | | 2012 | | 2013 | | 2012 |
| Saskatchewan | $ | 203,511 | $ | 207,431 | $ | 448,255 | $ | 578,643 |
| Alberta | | 342,548 | | 81,846 | | 546,475 | | (26,643) |
| Manitoba | | 6,510 | | - | | 46,905 | | - |
| British Columbia | | 16 | | 22 | | 54 | | 119 |
| | $ | 552,585 | $ | 289,299 | $ | 1,041,689 | $ | 552,119 |
| % of Revenue: | | | | | | | | |
| Saskatchewan | | 6% | | 7% | | 6% | | 7% |
| Alberta | | 16% | | 31% | | 13% | | -4% |
| Manitoba | | 5% | | 0% | | 7% | | 0% |
| British Columbia | | 0% | | 3% | | 0% | | 1% |
| Total Company | | 10% | | 8% | | 9% | | 6% |

Royalties as a percentage of revenue increased to 10% in the second quarter of 2013 from 8% in the prior year. On a year to date basis, this rate increased to 9% from 6%.

The increase is the effective royalty rate is attributable to the higher revenue and the corresponding royalties from Alberta, in particular from the Kakwa-Resthaven area. Production in this area is currently subject to overriding royalties ranging from 2% to 12% in addition to royalties payable to the Crown. Production in this area also benefits from the Crown's New Well Royalty ("NWR") program and the Natural Gas Deep Drilling program ("NGDDP"). Under NWR, the royalty rate payable on all products from qualifying wells is 5% subject to a 500 MMcf volume cap. Under the NGDDP, the Company receives a royalty credit based on the total measured depth of the wells drilled.

*Operating Costs*

| | | Three months ended June 30, | | | | Six months ended June 30, | | |
|---|---|---|---|---|---|---|---|---|
| | | 2013 | | 2012 | | 2013 | | 2012 |
| Saskatchewan | $ | 527,724 | $ | 871,595 | $ | 1,322,053 | $ | 1,545,804 |
| Alberta | | 482,399 | | 280,222 | | 1,075,282 | | 474,185 |
| Manitoba | | 15,705 | | - | | 81,695 | | - |
| British Columbia | | 35,042 | | 5,710 | | 64,102 | | 28,547 |
| | $ | 1,060,870 | $ | 1,157,527 | $ | 2,543,132 | $ | 2,048,536 |
| $/boe: | | | | | | | | |
| Saskatchewan | | 14.83 | | 22.86 | | 17.05 | | 17.12 |
| Alberta | | 13.42 | | 29.05 | | 14.24 | | 21.53 |
| Manitoba | | 10.15 | | - | | 10.04 | | - |
| British Columbia | | 22.65 | | - | | 18.85 | | 19.61 |
| Total Company | | 14.22 | | 24.23 | | 15.45 | | 18.01 |

On a unit of production cost basis, operating costs improved over the second quarter of 2012 from $24.23 per boe to $14.22 per boe in the current year. For the first six months of the year, operating costs averaged $15.45 per boe (2012: $18.01 per boe).

Despite the impact of production shut-ins at Antler, operating costs in Saskatchewan declined over the prior year and the prior quarter. This is attributable to the reduction of rental, fuel and trucking costs due to the tie-in of existing wells to the main battery and the local electricity grid. In Alberta, operating costs on a boe basis, also decreased over the prior year due to the production in 2013 from the Kakwa-Resthaven area. In 2012, production from Alberta was primarily from the Vulcan area where the relatively large proportion of fixed costs was borne by declining production in the area.

*General and Administrative Expenses*

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| General and administrative expenses, gross | $ 1,606,351 | $ 1,821,046 | $ 3,075,428 | $ 3,772,011 |
| Capitalized expenses and overhead recoveries | (344,980) | (734,796) | (854,374) | (1,503,787) |
| General and administrative expenses, net | $ 1,261,371 | $ 1,086,250 | $ 2,221,054 | $ 2,268,224 |

Despite a reduction in gross general and administrative expenses ("G&A"), net G&A in the second quarter of 2013 increased to $1.26 million from $1.09 million in the second quarter of 2012 due to lower capitalized expenses and overhead recoveries.

*Other Income and Expenses*

Changes to the fair value of the Company's risk management contracts are recorded through net profit and loss. For the Company's outstanding risk management contracts at June 30, 2013, the unrealized gain (loss) recorded in net profit (loss) for the six months ended June 30, 2013 was $(0.53) million (2012: $0.93 million). For the Company's settled risk management contracts at June 30, 2013, the realized gain recorded in net profit (loss) for six months ended June 30, 2013 was $0.14 million (2012: $0.11 million).

Marketable securities represent investments in shares of public companies which are designated as available for sale and are stated at fair value. Any unrealized gain or loss is recognized in other comprehensive income (loss) for the period in which they arise. At June 30, 2013, the Company held no marketable securities. The Company recorded a loss, net of deferred tax, of $0.10 million in the second quarter of 2012 and a gain, net of deferred tax, in the first six months of 2012 of $1.90 million. In the first six months of 2012, Questerre sold all of the marketable securities for proceeds of $5.41 million resulting in a realized gain of $0.29 million. With the sale of the marketable securities in the first six months of 2012, $0.29 million of other comprehensive income (loss) was reclassified to net profit (loss).

Questerre invested in senior secured convertible bonds in the second quarter of 2012. They mature on May 22, 2015 and have a coupon rate of 12%. The change in fair value of the investment in convertible bonds in the second quarter of 2013 resulted in a loss of $1.57 million (2012: $0.11 million). For the quarter ended June 30, 2013, the Company recorded an impairment in its investment in convertible bonds. Based on its assessment of the issuer's current financial position, the Company determined the impairment based on recent market prices of the underlying shares.

Questerre reported interest income of $0.26 million for the first six months of the year (2012: $0.56 million) and $0.15 million for the three months ended June 30, 2013 (2012: $0.23 million). The interest is from the cash invested in Guaranteed Investment Certificates issued by Canadian chartered banks and credit unions and from the Company's investment in convertible bonds. The decrease in the interest income is a result of the Company's lower cash balance in the current year.

The gain on foreign exchange, net of deferred tax, through other comprehensive income (loss) of $1.34 million in the second quarter of 2013 (2012: $0.67 million) and $2.12 million for the first six months of 2013 (2012: $0.59 million) is due to the change in the exchange rate relating to its US dollar investments.

*Share Based Compensation*

Under the Company's current share based compensation plan, fair values are determined at each reporting date using the Black-Scholes option pricing model. Periodic changes in fair value are recognized in net profit (loss) as share based compensation expense (recovery) with a corresponding change to the liability. Potential commitments for cash payments under the share based compensation plan are recorded as a share based compensation liability based on the fair value of the liability at the reporting date.

Share based compensation expense (recovery) for the second quarter of 2013 was $(0.46) million as compared to $0.27 million in the second quarter of 2012. Share based compensation expense for the six months ended June 30, 2013 was $1.09 million as compared to $1.35 million for the six months ended June 30, 2012. Due to the increase in the Company's share price in 2013, the Black-Scholes values have increased resulting in an expense in 2013.

*Depletion, Depreciation, Impairment and Accretion*

Questerre recorded $2.25 million or $30.10/boe of depletion and depreciation expense for the quarter ended June 30, 2013 compared to $1.83 million or $38.41/boe for the same period in 2012. For the six months ended June 30, 2013, the Company recorded $4.91 million or $29.86/boe of depletion and depreciation expense compared to $4.38 million or $38.54/boe for the same period in 2012. The gross increase in depletion and depreciation expense is due to an increase in production from 2012. This was partially offset by a higher production weighting from cash generating units with lower finding and development costs.

The impairment of assets of $0.04 million in the second quarter of 2013 (2012: $0.09 million) and $0.89 million for the first six months of 2013 (2012: $1.74 million) relate to undeveloped land expiries within the exploration and evaluation asset pool.

*Deferred Taxes*

For the three and six months ended June 30, 2013, Questerre reported a deferred tax expense (recovery) of $0.02 million and $(0.19) million, respectively (2012: $0.29 million and $0.01 million, respectively). Questerre had sufficient tax pool deductions to offset taxable income in 2013.

### Total Comprehensive Income (Loss)

Questerre's total comprehensive income for the second quarter of 2013 was $0.66 million as compared to $0.67 million in the second quarter of 2012. The change in the Company's total comprehensive income for this period is mainly attributable to higher petroleum and natural gas revenue and a higher gain on foreign exchange relating to its US dollar investments, partially offset by the lower gain recorded on the Company's risk management contracts in 2013 as compared to the prior year and the loss on investment in convertible bonds.

The Company's total comprehensive income (loss) for the six months ended June 30, 2013 was $(0.12) million as compared to $0.50 million for the six months ended June 30, 2012. The Company's change in total comprehensive income (loss) for this period is mainly attributable to a higher loss on investment on convertible bonds in 2013 and the gain on sale of marketable securities recorded in 2012, partially offset by higher petroleum and natural gas revenue, a higher gain on foreign exchange relating to the Company's US dollar investments and lower impairment charges.

*Capital Expenditures*

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2013** | 2012 | **2013** | 2012 |
| Alberta | **$ 3,838,697** | $ 2,085,527 | **$ 27,747,127** | $ 3,753,686 |
| Saskatchewan | **(136,399)** | 2,855,445 | **1,215,567** | 15,503,507 |
| Quebec | **37,724** | 342,538 | **515,673** | 657,715 |
| Wyoming | **32,813** | - | **132,813** | - |
| Manitoba | **67,474** | 3,160 | **161,243** | 18,704 |
| British Columbia | **10,520** | 16,352 | **32,029** | 25,846 |
| Corporate | **-** | 60,331 | **7,231** | 195,568 |
| | **3,850,829** | 5,363,353 | **29,811,683** | 20,155,026 |
| Dispositions | **(52,600)** | (175,000) | **(52,600)** | (175,000) |
| Total | **$ 3,798,229** | $ 5,188,353 | **$ 29,759,083** | $ 19,980,026 |

For the six months ended June 30, 2013, the Company incurred net capital expenditures of $29.76 million as follows:

- In Alberta, the Company spent $27.75 million, including $19.1 million to acquire acreage prospective for the liquids-rich Montney and the remainder mainly to drill and complete wells targeting this formation.
- In Saskatchewan, the Company spent $1.22 million, including $1.2 million to drill one infill well and acquire 3-D seismic data in Antler and $0.18 million for work relating to the Pasquia Hills oil shale acreage. Offsetting these expenses was a refund of $0.40 million relating to a service adjustment for completion services performed in 2012.
- In the St. Lawrence Lowlands of Quebec the Company spent $0.52 million for remedial work on its existing test wells and working to secure the Company's social license to operate in the province.

For the six months ended June 30, 2012, the Company incurred net capital expenditures of $19.98 million as follows:

- In Saskatchewan, $15.50 million was incurred mainly to drill, complete and tie-in several wells. Included in the Saskatchewan total is $1.61 million relating to the evaluation of the Pasquia Hills area prospective for oil shale.
- $3.75 million spent in Alberta relates to the drilling and completion of one (0.38 net) well for the Montney.

- In Quebec, $0.66 million was invested primarily to secure the Company's social license to operate.
- The disposition of $0.18 million related to the sale of a non-core property in Alberta.

## Liquidity and Capital Resources

Questerre had a working capital surplus of $10.61 million at June 30, 2013 as compared to $33.22 million at December 31, 2012. The Company's capital investment program for 2013 is focused on further development of its Kakwa-Resthaven, Antler, and Pierson assets. The Company believes it is sufficiently capitalized to fund this program from its working capital surplus, cash flow from operations and available conventional debt facilities.

*Cash Flow from Operating Activities*

Net cash from operating activities for the three months ended June 30, 2013 and 2012 was $3.87 million and $3.54 million, respectively. The increase in net cash from operating activities for this period was due to higher cash flow from operations, partially offset by the negative change in non-cash working capital. The increase in cash flow from operations is mainly due to higher petroleum and natural gas sales and lower operating costs, partially offset by higher royalties.

Net cash from operating activities for the six months ended June 30, 2013 and 2012 was $7.57 million and $4.28 million, respectively. The increase in net cash from operating activities for this period of $3.29 million was due to higher cash flow from operations and the positive change in the non-cash working capital.

*Cash Flow used in Investing Activities*

Cash flow used in investing activities was $6.35 million for the quarter ended June 30, 2013 and $35.26 million for the six months ended June 30, 2013. For the three and six months ended June 30, 2012, the Company's cash flow used in investing activities was $15.87 million and $60.2 million, respectively.

For the six months ended June 30, 2013, the Company incurred capital expenditures of $29.81 million compared to $20.16 million for the same period in 2012. The higher net capital expenditures were due to increased investment activity in the Kakwa-Resthaven area, primarily to acquire land, partially offset by less drilling and completion activity in Antler in 2013. In the first six months of 2012, Questerre acquired approximately 6% of the equity capital of Red Leaf for $43.17 million and invested in senior secured convertible bonds for $2.22 million. Non-cash working capital relating to investing activities decreased by $5.50 million for the six months ended June 30, 2013 as a compared to $0.24 million for the six months ended June 30, 2012 mainly due to the higher accounts receivable balance in 2013 relating to a control of well incident that occurred in January 2013.

*Cash Flow from (used in) Financing Activities*

Cash flow from (used in) financing activities was $0.16 million and $2.02 million for the three and six months ended June 30, 2013, respectively, and $(0.39) million and $(0.52) million for the three and six months ended June 30, 2012, respectively. The increase from the prior periods is due to the proceeds received on share option exercises in 2013 as compared to the repurchase of shares in 2012 under the Company's normal course issuer bid.

*Share Capital*

The following table provides a summary of the outstanding common shares and options as at the date of the MD&A, the current quarter end and the preceding year-end.

| | August 14, 2013 | June 30, 2013 | December 31, 2012 |
|---|---|---|---|
| Common shares | 235,297,538 | 235,297,538 | 230,804,204 |
| Stock options | 17,023,335 | 13,898,335 | 21,349,169 |
| Weighted average common shares | | | |
| Basic | | 234,083,413 | 230,913,671 |
| Diluted | | 234,829,930 | 232,774,483 |

A summary of the Company's stock option activity during the six months ended June 30, 2013 and year ended December 31, 2012 follows:

| | June 30, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price |
| Outstanding, beginning of period | 21,349,169 | $2.24 | 22,674,169 | $2.27 |
| Granted | 502,500 | 0.86 | 1,140,000 | 0.68 |
| Forfeited | (1,030,000) | 2.33 | (1,950,000) | 2.09 |
| Expired | (2,430,000) | 4.70 | (255,000) | 0.90 |
| Exercised | (4,493,334) | 0.45 | (260,000) | 0.45 |
| Outstanding, end of period | 13,898,335 | $2.34 | 21,349,169 | $2.24 |
| Exercisable, end of period | 7,423,124 | $2.99 | 12,972,560 | $2.48 |

## Risk Management

The Company's activities in the petroleum and natural gas industry expose it to a variety of financial risks, including credit, liquidity and market risks associated with commodity prices, exchange rate and interest rate fluctuations. There have been no changes to the Company's risks from those detailed in the MD&A for the year ended December 31, 2012.

The Company may use financial instruments to reduce corporate risk in certain situations. At June 30, 2013, Questerre had the following commodity risk management contracts in place:

| | Volumes | Average Price | Term | Fair Value Asset (Liability) |
|---|---|---|---|---|
| WTI NYMEX oil swap | 150 bbl/d | $99.65/bbl | Jan. 1, 2013 - Dec. 31, 2013 | $ (17,894) |
| WTI NYMEX oil swap | 150 bbl/d | $98.20/bbl | Mar. 1, 2013 - Dec. 31, 2013 | (62,222) |
| WTI NYMEX oil swap | 150 bbl/d | $94.70/bbl | Jan. 1, 2014 - Dec. 31, 2014 | (45,780) |
| | | | | $ (125,896) |

## Accounting Policy Changes

Effective January 1, 2013, the Company adopted the following new standards and interpretations:

IFRS 10 *Consolidated Financial Statements*

IFRS 10 revised the definition of control and requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. It also included guidance related to an investor with decision making rights to determine if it is acting as a principal or agent. IFRS 10 replaced SIC-12 Consolidation—Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

IAS 27 was amended to conform to the changes made in IFRS 10 but retains the current guidance for separate financial statements.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 11 *Joint Arrangements*

IFRS 11 which requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. IFRS 11 supersedes IAS 31 *Interests in Joint Ventures*, and SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers*.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 12 *Disclosure of Interest in Other Entities*

IFRS 12 establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates and unconsolidated structured entities. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities. IFRS 12 replaces disclosure requirements previously included in IAS 27, IAS 31 and IAS 28 *Investments in Associates*.

IAS 28 has been amended to conform to the changes made in IFRS 10 and IFRS 11.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 13 *Fair Value Measurement*

IFRS 13 establishes a single framework for fair value measurement and disclosures when fair value is required or permitted under IFRS. Adoption of the standard did not require adjustments to the valuation techniques used by the Company to measure fair value and did not result in any measurement adjustments as at January 1, 2013. Adopting this accounting change had no impact on the Company's financial statements.

IAS 1 *Presentation of Financial Statements*

Amendments to IAS 1 require companies preparing financial statements in accordance with IFRS to group together items within other comprehensive income that may be reclassified to the profit or loss section of the income statement. The amendment affected presentation only and had no impact on the Company's financial position or performance.

## Internal Controls over Financial Reporting

Questerre is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". The 2013 certificate requires that the Company disclose in the interim MD&A any changes in the Company's internal controls over financial reporting ("ICFR") that occurred during the period that have materially affected, or are reasonably likely to materially affect the Company's ICFR.

Management completed an assessment of the ICFR. During the process of management's assessment, it was determined that certain weaknesses existed in ICFR. The weaknesses are the result of the Company's size and limited number of staff and include: (i) the inability to achieve complete segregation of duties; and (ii) having insufficient staff with the required technical tax knowledge to deal with complex and non-routine matters. The Company believes that these weaknesses are mitigated by: (i) the President and Chief Executive Officer and the Chief Financial Officer overseeing all material transactions; (ii) the audit committee, comprised of independent members of the Board of Directors, reviewing the quarterly interim and annual audited financial statements with management; (iii) the Board of Directors' approval of the financial statements based on the audit committee's recommendation after its review; and (iv) the Company consulting with its third party expert advisors as needed in connection with the recording and reporting of complex and non-routine transactions.

There were no significant changes in Questerre's ICFR during the quarter ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's ICFR.

It should be noted that a control system, including the Company's disclosure and internal controls and procedures, no matter how well conceived can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

## Quarterly Financial Information

| | June 30, 2013 | March 31, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|---|
| Production (boe/d) | 820 | 1,000 | 766 | 696 |
| Average Realized Price ($/boe) | 74.84 | 71.57 | 74.22 | 75.64 |
| Petroleum and Natural Gas Sales | 5,584,673 | 6,440,913 | 5,231,973 | 4,842,799 |
| Cash Flow from Operations | 2,962,065 | 3,649,006 | 2,898,223 | 2,834,293 |
| Per share - Basic | 0.01 | 0.02 | 0.01 | 0.01 |
| Per share - Diluted | 0.01 | 0.02 | 0.01 | 0.01 |
| Net Profit (Loss) | (677,981) | (1,569,065) | (17,658,572) | (110,757) |
| Per share - Basic | - | (0.01) | (0.08) | - |
| Per share - Diluted | - | (0.01) | (0.08) | - |
| Capital Expenditures, net of acquisitions and dispositions | 3,798,229 | 25,960,854 | 12,981,123 | 9,389,246 |
| Working Capital Surplus | 10,608,203 | 12,843,617 | 33,215,954 | 40,597,138 |
| Total Assets | 246,660,044 | 251,827,981 | 243,365,009 | 257,813,560 |
| Shareholders' Equity | 221,695,564 | 220,577,950 | 217,456,454 | 234,846,041 |
| Weighted Average Common Shares Outstanding | | | | |
| Basic | 235,239,846 | 232,914,130 | 230,804,204 | 230,793,334 |
| Diluted | 235,546,412 | 234,041,880 | 232,665,015 | 232,420,240 |

| | June 30, 2012 | March 31, 2012 | December 31, 2011 | September 30, 2011 |
|---|---|---|---|---|
| Production (boe/d) | 525 | 725 | 743 | 604 |
| Average Realized Price ($/boe) | 72.10 | 80.68 | 85.42 | 77.93 |
| Petroleum and Natural Gas Sales | 3,444,473 | 5,323,158 | 5,839,520 | 4,330,124 |
| Cash Flow from Operations | 1,220,773 | 3,291,154 | 3,149,746 | 3,008,565 |
| Per share - Basic | 0.01 | 0.01 | 0.01 | 0.01 |
| Per share - Diluted | 0.01 | 0.01 | 0.01 | 0.01 |
| Net Profit (Loss) | 130,555 | (1,833,286) | (4,030,018) | 1,758,768 |
| Per share - Basic | - | (0.01) | (0.02) | 0.01 |
| Per share - Diluted | - | (0.01) | (0.02) | 0.01 |
| Capital Expenditures, net of acquisitions and dispositions | 5,188,353 | 14,791,673 | 12,490,404 | 19,726,206 |
| Working Capital Surplus | 47,350,400 | 55,051,962 | 104,480,657 | 114,194,728 |
| Total Assets | 256,759,200 | 267,006,166 | 258,409,889 | 258,890,553 |
| Shareholders' Equity | 233,859,513 | 233,136,765 | 232,877,970 | 236,592,124 |
| Weighted Average Common Shares Outstanding | | | | |
| Basic | 230,945,633 | 231,114,039 | 232,055,963 | 232,115,528 |
| Diluted | 232,955,303 | 232,694,570 | 233,991,289 | 234,382,606 |

The general trends over the last eight quarters are as follows:

- Production has decreased to 820 boe/d for the second quarter of 2013 from 1,000 boe/d for the first quarter of 2013. The decreased production from the prior quarter is mainly due to production shut-ins of single well batteries in Saskatchewan and Manitoba during spring breakup. The Company realized increased production from its Kakwa-Resthaven area in 2013.
- In general, the working capital surplus has decreased as the capital expenditures have been higher than the cash flow from operations. The significant decline in the first quarter of 2012 was due to the US$40 million investment in Red Leaf. The Company also purchased land in Kakwa-Resthaven and Wapiti in the first quarter of 2013 for approximately $19 million.
- Cash flow from operations has decreased to $2.96 million for the three months ended June 30, 2013 from $3.65 million for the three months ended March 31, 2013 mainly due to production shut-ins in Saskatchewan and Manitoba during spring breakup. Cash flow from operations increased to $2.96 million for the three months ended June 30, 2013 from $1.22 million from the same period in 2012 due to the increase in production from the Kakwa-Resthaven area.

# Condensed Consolidated Interim Balance Sheets *(unaudited)*

| *(Canadian dollars)* | Note | June 30, 2013 | December 31, 2012 |
|---|---|---|---|
| **Assets** | | | |
| Current Assets | | | |
| Cash and cash equivalents | | $ 16,877,922 | $ 42,540,650 |
| Investment in convertible bonds | 3 | 582,431 | 2,064,170 |
| Accounts receivable | 11 | 9,823,413 | 4,944,911 |
| Current portion of risk management contracts | 11 | - | 399,157 |
| Deposits and prepaid expenses | | 545,547 | 546,288 |
| | | 27,829,313 | 50,495,176 |
| Investments | 4 | 45,540,796 | 43,101,219 |
| Property, plant and equipment | 5 | 88,907,027 | 88,817,951 |
| Exploration and evaluation assets | 6 | 69,022,841 | 45,476,529 |
| Risk management contracts | 11 | 13,318 | - |
| Goodwill | | 2,345,944 | 2,345,944 |
| Deferred tax assets | | 13,000,805 | 13,128,190 |
| | | $ 246,660,044 | $ 243,365,009 |
| **Liabilities** | | | |
| Current Liabilities | | | |
| Accounts payable and accrued liabilities | | $ 17,221,110 | $ 16,880,065 |
| Current portion of risk management contracts | 11 | 139,214 | - |
| Current portion of share based compensation liability | 9 | 917,563 | 1,945,274 |
| | | 18,277,887 | 18,825,339 |
| Share based compensation liability | 9 | 340,643 | 439,212 |
| Asset retirement obligation | 7 | 6,345,950 | 6,644,004 |
| | | 24,964,480 | 25,908,555 |
| **Shareholders' Equity** | | | |
| Share capital | 8 | 311,078,623 | 307,034,623 |
| Contributed surplus | | 16,498,103 | 16,179,385 |
| Accumulated other comprehensive income | | 3,791,925 | 1,668,487 |
| Deficit | | (109,673,087) | (107,426,041) |
| | | 221,695,564 | 217,456,454 |
| | | $ 246,660,044 | $ 243,365,009 |

Subsequent events (note 12)

*The notes are an integral part of these condensed consolidated interim financial statements.*

# Condensed Consolidated Interim Statements of Comprehensive Income *(unaudited)*

| *(Canadian dollars)* | Note | Three months ended June 30, 2013 | Three months ended June 30, 2012 | Six months ended June 30, 2013 | Six months ended June 30, 2012 |
|---|---|---|---|---|---|
| Revenue | | | | | |
| Petroleum and natural gas sales | | $ 5,584,673 | $ 3,444,473 | $ 12,025,586 | $ 8,767,631 |
| Royalties | | (552,585) | (289,299) | (1,041,689) | (552,119) |
| Petroleum and natural gas revenue, net of royalties | | 5,032,088 | 3,155,174 | 10,983,897 | 8,215,512 |
| Expenses | | | | | |
| Direct operating | | 1,060,870 | 1,157,527 | 2,543,132 | 2,048,536 |
| General and administrative | | 1,261,371 | 1,086,250 | 2,221,054 | 2,268,224 |
| Pre-exploration | | - | 25,695 | 8,333 | 49,817 |
| Loss (gain) on risk management contracts | 11 | 20,347 | (1,394,139) | 382,124 | (1,044,362) |
| Loss (gain) on divestiture | | 72,409 | (220,214) | 72,409 | (220,214) |
| Loss (gain) on investment in convertible bonds | 3 | 1,569,600 | 110,602 | 1,432,971 | 110,602 |
| Loss on foreign exchange | | (15,665) | 2,076 | 45,952 | 2,076 |
| Reclass from OCI relating to marketable securities and investments | | - | (28,806) | - | (285,178) |
| Depletion and depreciation | 5 | 2,246,249 | 1,834,832 | 4,914,708 | 4,383,513 |
| Impairment of assets | 6 | 39,112 | 91,602 | 893,619 | 1,743,991 |
| Accretion of asset retirement obligation | 7 | 33,958 | 34,341 | 67,636 | 66,564 |
| Share based compensation (recovery) | 9 | (455,672) | 266,140 | 1,093,203 | 1,354,902 |
| Interest income | | 147,205 | 228,576 | 255,995 | 563,682 |
| Other income (expense) | | (551) | - | (551) | - |
| Profit (loss) before taxes | | (653,837) | 417,844 | (2,435,800) | (1,699,277) |
| Deferred taxes (recovery) | | 24,144 | 287,289 | (188,754) | 3,454 |
| Net profit (loss) | | (677,981) | 130,555 | (2,247,046) | (1,702,731) |
| Other comprehensive income (loss), net of tax | | | | | |
| Gain (loss) on marketable securities | | - | (101,526) | - | 1,898,145 |
| Gain on foreign exchange | 4 | 1,342,407 | 670,553 | 2,123,438 | 588,592 |
| Reclass to profit (loss) relating to marketable securities | | - | (28,806) | - | (285,178) |
| | | 1,342,407 | 540,221 | 2,123,438 | 2,201,559 |
| Total comprehensive income (loss) | | $ 664,426 | $ 670,776 | $ (123,608) | $ 498,828 |
| Net profit (loss) per share | | | | | |
| Basic and diluted | 8 | $ - | $ - | $ (0.01) | $ (0.01) |

*The notes are an integral part of these condensed consolidated interim financial statements.*

# Condensed Consolidated Interim Statements of Changes in Equity *(unaudited)*

| *(Canadian dollars)* | Note | Six months ended June 30, 2013 | 2012 |
|---|---|---|---|
| **Share Capital** | | | |
| Balance, beginning of period | | $ 307,034,623 | $ 307,856,902 |
| Options exercised | 8 | 4,044,000 | 8,700 |
| Repurchase of shares under normal course issuer bid | | - | (1,005,979) |
| Balance, end of period | | 311,078,623 | 306,859,623 |
| **Contributed Surplus** | | | |
| Balance, beginning of period | | 16,179,385 | 14,588,016 |
| Reclassification of share based compensation | 9 | 318,718 | 994,499 |
| Repurchase of shares under normal course issuer bid | | - | 485,495 |
| Balance, end of period | | 16,498,103 | 16,068,010 |
| **Accumulated Other Comprehensive Income (Loss)** | | | |
| Balance, beginning of period | | 1,668,487 | (1,612,967) |
| Other comprehensive income | | 2,123,438 | 2,201,559 |
| Balance, end of period | | 3,791,925 | 588,592 |
| **Deficit** | | | |
| Balance, beginning of period | | (107,426,041) | (87,953,981) |
| Net loss | | (2,247,046) | (1,702,731) |
| Balance, end of period | | (109,673,087) | (89,656,712) |
| **Total Shareholders' Equity** | | $ 221,695,564 | $ 233,859,513 |

*The notes are an integral part of these condensed consolidated interim financial statements.*

# Condensed Consolidated Interim Statements of Cash Flows *(unaudited)*

| *(Canadian dollars)* | Note | Three months ended June 30, 2013 | 2012 | Six months ended June 30, 2013 | 2012 |
|---|---|---|---|---|---|
| **Operating Activities** | | | | | |
| Net profit (loss) | | $ (677,981) | $ 130,555 | $ (2,247,046) | $ (1,702,731) |
| Adjustments for: | | | | | |
| Depletion and depreciation | 5 | 2,246,249 | 1,834,832 | 4,914,708 | 4,383,513 |
| Impairment of assets | 6 | 39,112 | 91,602 | 893,619 | 1,743,991 |
| Accretion of asset retirement obligation | 7 | 33,958 | 34,341 | 67,636 | 66,564 |
| Share based compensation (recovery) | 9 | (455,672) | 266,140 | 1,093,203 | 1,354,902 |
| Unrealized (gain) loss on risk management contracts | 11 | 123,095 | (1,275,398) | 525,053 | (932,806) |
| Loss (gain) on divestiture | | 72,409 | (220,214) | 72,409 | (220,214) |
| Loss on investment in convertible bonds | 3 | 1,569,600 | 110,602 | 1,432,971 | 110,602 |
| Unrealized (gain)loss on foreign exchange | | (12,849) | 2,076 | 48,768 | 2,076 |
| Reclass from OCI on sale of marketable securities | | - | (28,806) | - | (285,178) |
| Deferred taxes (recovery) | | 24,144 | 287,289 | (188,754) | 3,454 |
| Abandonment expenditures | | - | (12,246) | (1,496) | (12,246) |
| Cash flow from operations | | 2,962,065 | 1,220,773 | 6,611,071 | 4,511,927 |
| Change in non-cash working capital | | 905,254 | 2,318,009 | 961,851 | (232,345) |
| Net cash from operating activities | | 3,867,319 | 3,538,782 | 7,572,922 | 4,279,582 |
| **Investing Activities** | | | | | |
| Property, plant and equipment expenditures | 5 | (615,486) | (1,968,465) | (4,774,955) | (13,884,899) |
| Exploration and evaluation expenditures | 6 | (3,235,343) | (3,394,888) | (25,036,728) | (6,270,127) |
| Sale of property, plant and equipment and exploration and evaluation assets | | 52,600 | 175,000 | 52,600 | 175,000 |
| Proceeds from sale of marketable securities | | - | 3,062,556 | - | 5,412,122 |
| Purchase of investments | 4 | - | (3,109,350) | - | (43,170,850) |
| Purchase of convertible bonds | 3 | - | (2,223,776) | - | (2,223,776) |
| Change in non-cash working capital | | (2,550,920) | (8,408,110) | (5,498,567) | (238,123) |
| Net cash used in investing activities | | (6,349,149) | (15,867,033) | (35,257,650) | (60,200,653) |
| **Financing Activities** | | | | | |
| Proceeds from issue of share capital | | 157,500 | 4,500 | 2,022,000 | 4,500 |
| Shares repurchased | 8 | - | (395,540) | - | (520,484) |
| Net cash from (used in) financing activities | | 157,500 | (391,040) | 2,022,000 | (515,984) |
| Change in cash and cash equivalents | | (2,324,330) | (12,719,291) | (25,662,728) | (56,437,055) |
| Cash and cash equivalents, beginning of period | | 19,202,252 | 63,848,634 | 42,540,650 | 107,566,398 |
| Cash and cash equivalents, end of period | | $ 16,877,922 | $ 51,129,343 | $ 16,877,922 | $ 51,129,343 |
| Cash interest received | | $ 275,638 | $ 46,851 | $ 606,730 | $ 823,761 |

*The notes are an integral part of these condensed consolidated interim financial statements.*

## 1. Nature of Operations and Basis of Presentation

Questerre Energy Corporation ("Questerre" or the "Company") is a full cycle exploration and production company. The Company targets scalable high-impact projects and has developed a portfolio of exploration and production assets. These condensed consolidated interim financial statements of the Company as at and for the three and six months ended June 30, 2013 and 2012 comprise the Company and its wholly owned subsidiary in those periods controlled.

Questerre is incorporated under the laws of the Province of Alberta and is domiciled in Canada. The address of its registered office is 1650, 801 – 6th Avenue SW, Calgary, Alberta.

These condensed consolidated interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") applicable to the preparation of interim financial statements, including International Accounting Standard 34, "Interim Financial Reporting" ("IAS 34"). These condensed consolidated interim financial statements have been prepared following the same accounting policies and method of computation as the annual consolidated financial statements for the year ended December 31, 2012 with the exception of deferred taxes and the adoption of the new standards and interpretations as outlined in Note 2. Taxes in the interim periods are accrued using the tax rate that would be applicable to expected total annual profit or loss. The disclosures provided below are incremental to those included with the annual consolidated financial statements. Certain information and disclosures normally included in the notes to the annual consolidated financial statements have been condensed or have been disclosed on an annual basis only. Accordingly, these condensed consolidated interim financial statements should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2012, which have been prepared in accordance with IFRS as issued by the IASB.

These condensed consolidated interim financial statements of Questerre were approved by the Board of Directors on August 14, 2013.

## 2. Accounting Policy Changes

Effective January 1, 2013, the Company adopted the following new standards and interpretations:

IFRS 10 *Consolidated Financial Statements*

IFRS 10 revised the definition of control and requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. It also included guidance related to an investor with decision making rights to determine if it is acting as a principal or agent. IFRS 10 replaced SIC-12 *Consolidation—Special Purpose Entities* and parts of IAS 27 *Consolidated and Separate Financial Statements*.

IAS 27 was amended to conform to the changes made in IFRS 10 but retains the current guidance for separate financial statements.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 11 *Joint Arrangements*

IFRS 11 which requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. IFRS 11 supersedes IAS 31 *Interests in Joint Ventures*, and SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers*.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 12 *Disclosure of Interest in Other Entities*

IFRS 12 establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates and unconsolidated structured entities. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities. IFRS 12 replaces disclosure requirements previously included in IAS 27, IAS 31 and IAS 28 *Investments in Associates.*

IAS 28 has been amended to conform to the changes made in IFRS 10 and IFRS 11.

Adopting this accounting change had no impact on the Company's financial statements.

IFRS 13 *Fair Value Measurement*

IFRS 13 establishes a single framework for fair value measurement and disclosures when fair value is required or permitted under IFRS. Adoption of the standard did not require adjustments to the valuation techniques used by the Company to measure fair value and did not result in any measurement adjustments as at January 1, 2013. Adopting this accounting change had no impact on the Company's financial statements.

IAS 1 *Presentation of Financial Statements*

Amendments to IAS 1 require companies preparing financial statements in accordance with IFRS to group together items within other comprehensive income that may be reclassified to the profit or loss section of the income statement. The amendment affected presentation only and had no impact on the Company's financial position or performance.

## 3. Investment in Convertible Bonds

In May 2012, Questerre invested in senior secured convertible bonds. They mature May 22, 2015 and have a coupon rate of 12%. This financial asset has been designated to be measured as fair value through profit or loss.

The following table sets out the changes in the investment in convertible bonds:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Balance, beginning of period | $ 2,064,170 | $ - |
| Purchase of convertible bonds | - | 2,223,776 |
| Loss on investment in convertible bonds | (1,432,971) | (240,248) |
| Gain (loss) on foreign exchange | (48,768) | 80,642 |
| Balance, end of period | $ 582,431 | $ 2,064,170 |

For the quarter ended June 30, 2013, the Company recorded an impairment in its investment in convertible bonds. Based on its assessment of the issuer's current financial position, the Company determined the impairment based on recent market prices of the underlying shares.

## 4. Investments

The investments balance is comprised of the following private company investments:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Red Leaf Resources Inc. | $ 45,004,148 | $ 42,593,313 |
| Investment in other private company | 536,648 | 507,906 |
| | $ 45,540,796 | $ 43,101,219 |

The following table sets out the changes in investments:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Balance, beginning of period | $ 43,101,219 | $ 494,506 |
| Purchase of investments | - | 43,170,850 |
| Subscription refund | - | (2,437,835) |
| Gain on investments | - | 2,250,000 |
| Gain (loss) on foreign exchange | 2,439,577 | (376,302) |
| Balance, end of period | $ 45,540,796 | $ 43,101,219 |

For the period ended June 30, 2013, the gain on foreign exchange relating to investments was $2.44 million (2012: $0.68 million), which was recorded in other comprehensive income (loss) net of deferred tax of $0.32 million (2012: $0.09 million).

## 5. Property, Plant and Equipment

Reconciliation of the property, plant and equipment assets:

| | Oil and Natural Gas Assets | Other Assets | Total |
|---|---|---|---|
| Cost or deemed cost: | | | |
| Balance, December 31, 2011 | $ 103,584,368 | $ 1,128,880 | $ 104,713,248 |
| Additions | 17,761,156 | 152,082 | 17,913,238 |
| Transfer from exploration and evaluation assets | 10,583,398 | - | 10,583,398 |
| Balance, December 31, 2012 | 131,928,922 | 1,280,962 | 133,209,884 |
| Additions | 4,534,944 | 2,231 | 4,537,175 |
| Transfer from exploration and evaluation assets | 466,609 | - | 466,609 |
| **Balance, June 30, 2013** | **$ 136,930,475** | **$ 1,283,193** | **$ 138,213,668** |
| Accumulated depletion, depreciation and impairment losses: | | | |
| Balance, December 31, 2011 | $ 28,371,413 | $ 879,365 | $ 29,250,778 |
| Depletion and depreciation | 9,712,581 | 105,043 | 9,817,624 |
| Impairment | 5,323,531 | - | 5,323,531 |
| Balance, December 31, 2012 | 43,407,525 | 984,408 | 44,391,933 |
| Depletion and depreciation | 4,864,574 | 50,134 | 4,914,708 |
| **Balance, June 30, 2013** | **$ 48,272,099** | **$ 1,034,542** | **$ 49,306,641** |

| | Oil and Natural Gas Assets | Other Assets | Total |
|---|---|---|---|
| Net book value: | | | |
| At December 31, 2012 | $ 88,521,397 | $ 296,554 | $ 88,817,951 |
| **At June 30, 2013** | **$ 88,658,376** | **$ 248,651** | **$ 88,907,027** |

During the period ended June 30, 2013, the Company capitalized administrative overhead charges of $0.76 million (December 31, 2012: $0.56 million) including $0.10 million in capitalized stock based compensation expense directly related to development activities (December 31, 2012: $0.06 million). Included in the June 30, 2013 depletion calculation are future development costs of $52.2 million (December 31, 2012: $56.44 million).

## 6. Exploration and Evaluation Assets

Reconciliation of the exploration and evaluation assets:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Balance, beginning of period | $ 45,476,529 | $ 51,582,526 |
| Additions | 25,031,549 | 25,486,786 |
| Transfers to property, plant and equipment | (466,609) | (10,583,398) |
| Dispositions | (125,009) | - |
| Impairment (incl. undeveloped land expiries) | (893,619) | (21,009,385) |
| Balance, end of period | $ 69,022,841 | $ 45,476,529 |

During the period ended June 30, 2013, the Company capitalized administrative overhead charges of $0.21 million (December 31, 2012: $1.52 million) including $0.02 million of capitalized stock based compensation expense directly related to exploration and evaluation activities (December 31, 2012: $(0.04) million).

The impairment expense for the period ended June 30, 2013 is for undeveloped land expiries in Saskatchewan.

## 7. Asset Retirement Obligation

The Company's asset retirement and abandonment obligations result from its ownership interest in oil and natural gas assets. The total asset retirement obligation is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company has estimated the net present value of the asset retirement obligation to be $6.35 million as at June 30, 2013 (December 31, 2012: $6.64 million) based on an undiscounted total future liability of $9.36 million (December 31, 2012: $9.21 million). These payments are expected to be made over the next 37 years. The discount factor, being the risk-free rate related to the liabilities, is between 1.22% and 2.89% (December 31, 2012: 1.14% and 2.36%). An inflation rate of 3% over the varying lives of the assets is used to calculate the present value of the asset retirement obligation.

The following table provides a reconciliation of the Company's total asset retirement obligation:

| | | June 30, 2013 | | December 31, 2012 |
|---|---|---|---|---|
| Balance, beginning of period | $ | 6,644,004 | $ | 5,805,972 |
| Revisions due to change in discount rates | | (436,148) | | 120,349 |
| Revisions due to change in estimates | | 2,621 | | 80,355 |
| Liabilities incurred | | 69,333 | | 654,521 |
| Liabilities disposed | | - | | (45,214) |
| Liabilities settled | | (1,496) | | (102,312) |
| Accretion | | 67,636 | | 130,333 |
| Balance, end of period | $ | 6,345,950 | $ | 6,644,004 |

## 8. Share Capital

The Company is authorized to issue an unlimited number of Class A common voting shares. The Company is also authorized to issue an unlimited number of Class B common voting shares and an unlimited number of preferred shares, issuable in one or more series. At June 30, 2013, there were no Class B common voting shares or preferred shares outstanding.

### *a) Issued and outstanding – Class A Common Shares*

| | Number | | Amount |
|---|---|---|---|
| Balance, December 31, 2011 | 231,300,028 | $ | 307,856,902 |
| Issued on exercise of options | 260,000 | | 183,700 |
| Repurchased under normal course issuer bid | (755,824) | | (1,005,979) |
| Balance, December 31, 2012 | 230,804,204 | | 307,034,623 |
| Issued on exercise of options | 4,493,334 | | 4,044,000 |
| Balance, June 30, 2013 | 235,297,538 | $ | 311,078,623 |

*b) Per share amounts*

Basic net profit (loss) per share is calculated as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2013** | 2012 | **2013** | 2012 |
| Net profit (loss) | $ **(677,981)** | $ 130,555 | $ **(2,247,046)** | $ (1,702,731) |
| Issued common shares at beginning of period | **234,947,538** | 231,109,028 | **230,804,204** | 231,300,028 |
| Options exercised | **292,308** | 6,703 | **3,279,209** | 3,352 |
| Treasury stock reacquired | **-** | (170,098) | **-** | (273,544) |
| Weighted average number of common shares outstanding (basic) | **235,239,846** | 230,945,633 | **234,083,413** | 231,029,836 |
| Basic net profit (loss) per share | $ **-** | $ - | $ **(0.01)** | $ (0.01) |

Diluted net profit (loss) per share is calculated as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2013** | 2012 | **2013** | 2012 |
| Net profit (loss) | $ **(677,981)** | $ 130,555 | $ **(2,247,046)** | $ (1,702,731) |
| Weighted average number of common shares outstanding (basic) | **235,239,846** | 230,945,633 | **234,083,413** | 231,029,836 |
| Effect of outstanding options | **-** | 2,009,670 | **-** | - |
| Weighted average number of common shares outstanding (diluted) | **235,239,846** | 232,955,303 | **234,083,413** | 231,029,836 |
| Diluted net profit (loss) per share | $ **-** | $ - | $ **(0.01)** | $ (0.01) |

Under the current stock option plan, options can be exchanged for common shares of the Company or for cash at the Company's discretion. As a result, they are considered potentially dilutive and are included in the calculation of diluted profit per share for the period. The average market value of the Company's shares for purposes of calculating the dilutive effect of options was based on quoted market prices for the period that the options were outstanding. At June 30, 2013, 15,004,465 options (2012: 19,445,867) were excluded from diluted weighted average number of common shares outstanding calculation as their effect would have been anti-dilutive.

## 9. Share Based Compensation

The Company has a stock option program that provides for the issuance of options to its directors, officers and employees at or above grant date market prices. The options granted under the plan generally vest evenly over a three-year period starting at the grant date or one year from the grant date. The grants generally expire five years from the grant date or five years from the commencement of vesting.

The number and weighted average exercise prices of the stock options are as follows:

| | June 30, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price |
| Outstanding, beginning of period | 21,349,169 | $2.24 | 22,674,169 | $2.27 |
| Granted | 502,500 | 0.86 | 1,140,000 | 0.68 |
| Forfeited | (1,030,000) | 2.33 | (1,950,000) | 2.09 |
| Expired | (2,430,000) | 4.70 | (255,000) | 0.90 |
| Exercised | (4,493,334) | 0.45 | (260,000) | 0.45 |
| Outstanding, end of period | 13,898,335 | $2.34 | 21,349,169 | $2.24 |
| Exercisable, end of period | 7,423,124 | $2.99 | 12,972,560 | $2.48 |

The following table provides a reconciliation of the Company's share based compensation liability:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Balance, beginning of period | $ 2,384,486 | $ 2,584,678 |
| Amount transferred to contributed surplus | (318,718) | (1,105,874) |
| Share based compensation expense | 1,093,203 | 952,978 |
| Capitalized share based compensation | 121,235 | 19,404 |
| Reclassification to share capital on exercise of stock options | (2,022,000) | (66,700) |
| Balance, end of period | $ 1,258,206 | $ 2,384,486 |
| Current portion | $ 917,563 | $ 1,945,274 |
| Non-current portion | 340,643 | 439,212 |
| | $ 1,258,206 | $ 2,384,486 |

## 10. Capital Management

The Company believes it is well capitalized with cash flow from operations (an additional IFRS measure defined as net cash from operating activities before changes in non-cash operating working capital), available conventional debt facilities and a working capital surplus (defined as current assets less current liabilities excluding the current portions of the share based compensation liability and risk management contracts) of $10.61 million at June 30, 2013 (December 31, 2012: $33.22 million) consisting mainly of cash and cash equivalents.

The volatility of commodity prices has a material impact on Questerre's cash flow from operations. Questerre attempts to mitigate the effect of lower prices by entering into risk management contracts, shutting in production in unusually low pricing environments, reallocating capital to more profitable areas and reducing capital spending based on results and other market considerations.

The Company considers its capital structure to include shareholders' equity and any outstanding debt. The Company will adjust its capital structure to minimize its cost of capital through the issuance of shares, securing credit facilities and adjusting its capital spending. Questerre monitors its capital structure based on the current and projected cash flow from operations.

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Shareholders' equity | $ 221,695,564 | $ 217,456,454 |

## 11. Financial Risk Management and Determination of Fair Values

### *a) Overview*

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities such as credit risk, liquidity risk and market risk. The Company manages its exposure to these risks by operating in a manner that minimizes this exposure.

### *b) Fair value of financial instruments*

The Company's financial instruments as at June 30, 2013 included cash and cash equivalents, investment in convertible bonds, accounts receivable, risk management contracts, deposits, investments and accounts payable and accrued liabilities. As at June 30, 2013, the fair values of the Company's financial assets and liabilities approximate their carrying values due to the short-term maturity with the exception of the Company's investment in convertible bonds, investments and the risk management contracts which are recorded at fair value.

Disclosures about the inputs to fair value measurements are required, including their classification within a hierarchy that prioritizes the inputs to fair value measurement.

Level 1 Fair Value Measurements

Level 1 fair value measurements are based on unadjusted quoted market prices. The Company's Level 1 financial instruments consist of its investment in senior secured convertible bonds.

Level 2 Fair Value Measurements

Level 2 fair value measurements are based on valuation models and techniques where the significant inputs are derived from quoted indices.

The Company's financial derivative instruments are carried at fair value as at June 30, 2013 and are considered a Level 2 instrument. The fair value is determined by reference to independent monthly forward settlement prices and currency rates.

Level 3 Fair Value Measurements

Level 3 fair value measurements are based on unobservable information.

Investments– The fair values are determined using recent corporate transactions.

As at each reporting period, the Company will assess whether a financial asset is impaired, other than those classified as fair value through profit or loss. Any impairment loss will be included in net profit (loss) for the period.

### *c) Market risk*

Market risk is the risk that changes in market prices, such as commodity prices, foreign exchange rates and interest rates will affect the Company's net profit (loss) or the value of its financial instruments. The objective of the Company is to mitigate exposure to these risks while maximizing returns to the Company.

Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar and also world economic events that dictate the levels of supply and demand. The Company may enter into oil and natural gas contracts to protect, to the extent possible, its cash flows from future sales. The contracts reduce the volatility in sales revenue by locking in prices with respect to future deliveries of oil and natural gas.

As at June 30, 2013, the Company had the following outstanding commodity risk management contracts:

| | Volumes | Average Price | Term | | Fair Value Asset (Liability) |
|---|---|---|---|---|---|
| WTI NYMEX oil swap | 150 bbl/d | $99.65/bbl | Jan. 1, 2013 - Dec. 31, 2013 | $ | (17,894) |
| WTI NYMEX oil swap | 150 bbl/d | $98.20/bbl | Mar. 1, 2013 - Dec. 31, 2013 | | (62,222) |
| WTI NYMEX oil swap | 150 bbl/d | $94.70/bbl | Jan. 1, 2014 - Dec. 31, 2014 | | (45,780) |
| | | | | $ | (125,896) |

The Company's risk management position is as follows:

| | | June 30, 2013 | | December 31, 2012 |
|---|---|---|---|---|
| *Risk Management Assets* | | | | |
| Current portion | $ | - | $ | 399,157 |
| Non-current portion | | 13,318 | | - |
| | $ | 13,318 | $ | 399,157 |

| | | June 30, 2013 | | December 31, 2012 |
|---|---|---|---|---|
| *Risk Management Liabilities* | | | | |
| Current portion | $ | 139,214 | $ | - |
| | $ | 139,214 | $ | - |

The unrealized gain (loss) recorded in net profit (loss) for the six month period ended June 30, 2013 was $(0.53) million (June 30, 2012: $0.93 million). The realized gain recorded in net profit (loss) for the six month period ended June 30, 2013 was $0.14 million (June 30, 2012: $0.11 million).

The value of Questerre's commodity price risk management contracts fluctuate with changes in the underlying market price of crude oil. An increase of decrease of $5 to the Canadian dollar West Texas Intermediate ("WTI") price, with all other variables being held constant, would result in a $0.55 million increase or decrease to net profit (loss), respectively.

### *d) Credit risk*

Credit risk represents the potential financial loss to the Company if a customer or counterparty to a financial instrument fails to meet or discharge their obligation to the Company. Credit risk arises principally from the Company's receivables from joint venture partners and oil and gas marketers.

At June 30, 2013, the Company had $7.02 million outstanding from insurers relating to a control of well incident that occurred in January 2013. The claim was made for costs to bring the well to the condition existing prior to the incident. The Company considers this amount to be fully collectible.

## 12. Subsequent Events

In July 2013, the Company secured a $26.5 million credit facility with a Canadian chartered bank. The credit facility is a revolving operating demand loan. Any borrowing under the facility, with the exception of letters of credit, bears interest at the bank's prime interest rate and an applicable basis point margin based on the ratio of debt to cash flow measured quarterly. The bank's prime rate currently is 3% per annum. The facility is secured by a $26.5 million revolving credit agreement, a $50 million debenture with a first floating charge over all assets of the Company and a general assignment of books debts. No amounts have been withdrawn from the credit facility. Under the terms of the bank credit facility, the Company has provided its covenant that it will maintain an Adjusted Working Capital Ratio greater than 1.0. This ratio is defined as current assets, excluding unrealized hedging gains, to current liabilities, excluding bank debt and unrealized hedging losses.

In July 2013, 3,125,000 share options were granted to employees and directors of the Company at an exercise price of $0.88 per share.

# CORPORATE INFORMATION

## Directors

Les Beddoes, Jr.

Michael Binnion

Alain Sans Cartier

Peder Paus

Dennis Sykora

Bjorn Inge Tonnessen

## Officers

Michael Binnion
President and
Chief Executive Officer

John Brodylo
VP Exploration

Peter Coldham
VP Engineering and
Operations

Chris Daunhauer
VP Finance

Jason D'Silva
Chief Financial Officer

Robert Morrison
Chief Operating Officer
Western Canada

Ian Nicholson
VP Geology,
Western Canada

Maria Rees
Corporate Secretary

Rick Tityk
VP Land

## Bankers

Canadian Western Bank
200, 606 Fourth Street SW
Calgary, Alberta
T2P 1T1

## Legal Counsel

Borden Ladner Gervais LLP
1900, 520 Third Avenue SW
Calgary, Alberta
T2P 0R3

## Transfer Agent

Computershare Trust
Company of Canada
600, 530 Eighth Avenue SW
Calgary, Alberta
T2P 3S8

DNB Bank ASA
Dronning Eufemias gate 30
N-0021 Oslo, Norway

## Auditors

PricewaterhouseCoopers LLP
3100, 111 Fifth Avenue SW
Calgary, Alberta
T2P 5L3

## Independent Reservoir Engineers

McDaniel & Associates Consultants Ltd.
2200, 255 Fifth Avenue SW
Calgary, Alberta
T2P 3G6

Netherland, Sewell & Associates, Inc.
1601 Elm Street, Suite 4500
Dallas, Texas
75201

## Head Office

1650 AMEC Place
801 Sixth Avenue SW
Calgary, Alberta T2P 3W2
Telephone: (403) 777-1185
Facsimile: (403) 777-1578
Web: www.questerre.com
Email: info@questerre.com

## Stock Information

Toronto Stock Exchange
Oslo Stock Exchange
Symbol: QEC

1650 AMEC Place
801 Sixth Avenue SW
Calgary, Alberta T2P 3W2
Telephone: (403) 777-1185
Facsimile: (403) 777-1578
Web: www.questerre.com
Email: info@questerre.com