Madalena energy inc.

**MANAGEMENT'S DISCUSSION & ANALYSIS**

**FOR THE THREE MONTHS ENDED MARCH 31, 2014**

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*This Management's Discussion and Analysis of financial condition and results of operations ("MD&A") is based on information available to May 29, 2014 and should be read in conjunction with Madalena Energy Inc.'s ("Madalena" or the "Company") unaudited condensed interim consolidated financial statements for the three months period ended March 31, 2014 and the accompanying notes as well as the audited consolidated financial statements for the year ended December 31, 2013 and the accompanying notes. This MD&A contains forward-looking information about our current expectations, estimates, projections and assumptions. See the Advisory for information on the risk factors that could cause actual results to differ materially and the assumptions underlying our forward-looking information. Madalena's Management prepared the MD&A, while the Audit Committee of the Madalena Board of Directors (the "Board") reviewed and recommended its approval by the Board. Additional information relevant to the Company's activities contained in its continuous disclosure documents, including our quarterly and the Annual Information Form ("AIF") is available on SEDAR at www.sedar.com.*

**Basis of Presentation**

*This MD&A and the unaudited condensed interim consolidated financial statements and comparative information have been prepared in Canadian dollars, except where another currency has been indicated and have been prepared in accordance with International Financial Reporting Standards ("IFRS" or "GAAP") as issued by the International Accounting Standards Board. Production volumes are presented on a before royalties basis.*

*Unless otherwise indicated, tabular financial amounts, other than per share amounts, are in thousands of Canadian dollars.*

**Non-GAAP Measures**

*Certain financial measures in this document do not have a standardized meaning as prescribed by IFRS, such as netbacks and therefore are considered non-GAAP measures. These measures may not be comparable to similar measures presented by other issuers. These measures have been described and presented in order to provide shareholders and potential investors with additional measures for analyzing our ability to generate funds to finance our operations and information regarding our liquidity. The additional information should not be considered in isolation or as a substitute for measures prepared in accordance with IFRS. The definition and reconciliation of each non-GAAP measure is presented in the Financial Results section of this MD&A.*

## INTRODUCTION AND OVERVIEW

### Overview

Madalena is an independent, Canadian-based, domestic and international upstream oil and gas company whose main business activities include exploration, development and production of crude oil, natural gas liquids and natural gas.

Internationally, Madalena holds three blocks within the Neuquén basin in Argentina comprised of approximately 132,200 net acres consisting of the Coiron Amargo block (approximately 34,950 net acres), the Curamhuele block (approximately 50,600 net acres) and the Cortadera block (approximately 46,650 net acres).

Domestically, Madalena's core area of operations is located in the Greater Paddle River area of west-central Alberta, where the Corporation holds approximately 195 gross (153 net) sections of land (78% average working interest).

## FIRST QUARTER 2014 HIGHLIGHTS AND OUTLOOK

- Current production is approximately 1,600 boe/d;
- Q1 - 2014 production averaged 1,141 boe/d, an increase of 31% from Q1-2013;
- Operating netbacks averaged $29.61, an increase of 93% from Q1 -2013;
- Capital expenditures were $12.5 million or 26% of Madalena's $48 million 2014 capital budget. Expenditures for the balance of the year will be directed to a combination of high impact horizontal wells in the Sierras Blancas light oil play, unconventional Vaca Muerta shale wells, re-entries for unconventional reservoirs at Curamhuele and horizontal wells on the Canadian assets. Funding will come from existing working capital, cash flow, FX gains, and if necessary, the Company’s existing credit facility;
- At Coiron Amargo, Madalena and its partners have a drilling rig scheduled to mobilize to the block in June 2014 to continue drilling a combination of high impact horizontals and Vaca Muerta shale delineation wells;
- In Q1-2014, Madalena shot an approximately 75 square kilometer 3D seismic survey on the Curamhuele block. Processing and merging of this data is currently underway and once finished, Madalena will have coverage on the entire northern portion of the Curamhuele block;
- Raised $23 million in February 2014; and
- Exited the quarter with $19.5 million in working capital and unutilized credit facilities of $13 million.

**SUMMARY FINANCIAL AND OPERATIONAL RESULTS**

| | Three months ended March 31 | |
|---|---|---|
| | **2014** | 2013 |
| **Financial -** Canadian $000s, except per share amounts | | |
| Oil and gas revenue | **6,306** | 3,609 |
| Net income (loss) | **297** | (2,320) |
| Per share – basic and diluted | **0.00** | (0.01) |
| Capital expenditures | **12,548** | 16,975 |
| Working capital | **19,463** | 12,364 |
| **Equity outstanding** – 000s | | |
| Common shares | **396,886** | 316,091 |
| Stock options | **19,530** | 20,697 |
| **Operating** | | |
| *Average Daily Production* | | |
| Crude oil and condensate – Bbls/d | **529** | 316 |
| Natural gas – Mcf/d | **2,978** | 2,677 |
| NGLs – Bbls/d | **114** | 109 |
| Total - boe /d(1) | **1,141** | 872 |
| *Average Sales Prices* | | |
| Crude oil and condensate - $/Bbl | **85.02** | 78.63 |
| Natural gas - $/Mcf | **5.84** | 3.29 |
| NGLs - $/Bbl | **66.43** | 58.79 |
| Total - $/boe(1) | **61.38** | 45.99 |
| *Operating Netbacks*(1) | | |
| $/boe(1) | **29.61** | 15.37 |

(1) Refer to - "Numerical Amounts" in Advisory.

**International Operations - *Neuquén Basin, Argentina***

***Coiron Amargo Block***

- Industry activity in and around Madalena's Coiron Amargo block (approximately 34,950 net acres), including developments in the greater Loma La Lata and Loma Campana areas, has seen a significant step change from initial exploration and appraisal drilling in 2012 to an accelerated exploitation / development phase in the unconventional Vaca Muerta shale through 2013 and into 2014. Over 150 Vaca Muerta shale wells have been drilled in and around this area and a number of significant joint ventures (or other transactions) have been announced over the last 14 months. These largely involve large integrated exploration and production companies such as YPF, Chevron, Shell, Total SA, Wintershall, Petrobras and others. YPF and Chevron have announced a 140 well drilling program in 2014 targeting the Vaca Muerta shale to the west of Madalena's acreage and they expect to increase production from the Vaca Muerta shale in this area to approximately 80,000 bbls/d by 2017. Madalena's Coiron Amargo block is strategically positioned within this area of intense

Vaca Muerta shale resource development and Madalena continues to execute its business plan in this area.

- The Coiron Amargo block is divided into a North and South region with active drill programs being executed in both areas. Coiron Amargo Notre (the northern portion of the block) is currently under a 25 year exploitation (development) concession. The southern portion of the block, Coiron Amargo Sur, is currently under an exploration contract which was extended until November 8, 2014 by way of an official decree signed by the Province of Neuquén in Argentina on November 12, 2013. Subsequent to November 8, 2014, Madalena has the ability to extend Coiron Amargo Sur through further exploration, evaluation and/or exploitation (development) phases.
- The focus of Madalena's business plan for the Coiron Amargo block includes:
    - i) Continue to advance the Company's Vaca Muerta shale activities with a combination of new delineation wells and completion techniques (stimulations and/or multi-stage fracs);
    - ii) Drill, complete, test and tie-in a number of high impact horizontal wells targeting Vaca Muerta sourced light oil from the Sierras Blancas reservoir; and
    - iii) Technically assess deep gas potential on the block in response to offsetting industry activity.
- Recently, the Company has intensified its focus on the Vaca Muerta shale given the magnitude of the unconventional resource across the Coiron Amargo block. The block is strategically positioned within the Neuquén basin in the shallower portion of the Vaca Muerta oil window. Industry activity continues to increase offsetting the Coiron Amargo block where Madalena drilled the CAS.x-14 and the CAS.x-15 vertical wells in Coiron Amargo Sur for the Vaca Muerta shale in 2013. The CAS.x-14 and CAS.x-15 wells were drilled and cased encountering approximately 105 and 114 meters respectively of Vaca Muerta shale on logs. Completion (stimulation work and/or multi-stage frac) activities on these wells are expected to commence in Q2 – 2014.

- Madalena has implemented a balanced business strategy between unconventional shale delineation and high impact horizontal drilling. Accordingly, Madalena has successfully implemented North American based horizontal technology and experience on the Coiron Amargo block. The Company's first implementation of horizontal technology internationally saw the CAN.xr-2(h) well re-entered, drilled and completed horizontally in the Sierras Blancas light oil reservoir which is a high deliverability conventional reservoir sourced from the Vaca Muerta shale. The CAN.xr-2(h) well has now been producing since late 2013 and has exceeded management's expectations. Cumulative gross oil production for Q1-2014 was approximately 62,500 barrels of oil or approximately or 700 bbls/d (not including associated solution gas volumes). In early April 2014, the well was tied into a permanent pipeline system to the central plant and gas dehydration and compressor facility and, accordingly, associated solution gas volumes will be realized as sales in future quarters. Madalena has a 35% working interest in the CAN.xr-2(h) well.

- Encouraged by the results of the CAN.xr-2(h) horizontal, Madalena has commenced a multi-well horizontal drilling program for 2014. The CAN-15(h) well, in which the Company has a 35% working interest, was recently drilled horizontally in the Sierras Blancas light oil reservoir in the Coiron Amargo block to a total measured depth of 3,750 meters with a horizontal lateral section of approximately 692 meters in length. This well is the second horizontal well drilled into the Sierras Blancas conventional light oil reservoir on the Coiron Amargo block. The well was subsequently cased and completed with a 4.5" slotted liner and a multi-rate production test was carried out through temporary production facilities. Throughout the multi-rate production test, the CAN-15(h) well flowed without artificial lift equipment and was tested for approximately 75 hours at various choke settings ranging from 6 mm to 12 mm in size with the following flow rates observed during the test:
    - i) With the production test only being carried out on a portion of the horizontal lateral section as planned, the highest rates were achieved on a 12 mm choke setting, when the CAN-15(h) well

was flowed at a rate of 1,393 bbls/d of oil with 3,301 mcf/d of associated natural gas for a total of 1,943 Boe/d (72% oil) over a 5 hour period and at an average flowing pressure of approximately 1,263 psi.

ii) On an 8mm choke setting, the CAN-15(h) well was flowed at a rate of 745 bbls/d of oil with 1,990 mcf/d of associated natural gas for a total of 1,077 Boe/d (69% oil) over a 29 hour period and at an average flowing pressure of approximately 1,629 psi.

iii) During the test period of 75 hours, the total gross produced cumulative volumes were approximately 2,553 barrels of oil and approximately 7,210 mcf of natural gas, for a total of approximately 3,754 barrels of oil equivalent (68% oil) gross. No significant flowing pressure declines were observed throughout the testing period and water cuts ranged from 0% to 3% throughout the test period.

- Madalena and its partners have a drilling rig scheduled to mobilize to the block in June 2014 to continue drilling a combination of high impact horizontals and Vaca Muerta shale delineation wells.

***Curamhuele Block***

- The greater El Trapial / Curamhuele region is an evolving area within the Neuquén basin which is seeing increased exploration and appraisal activity for unconventional shale plays and tight sand reservoirs. Chevron has recently announced that a second focus area for Chevron in the Vaca Muerta shales is the El Trapial block which is adjacent and to the east of Madalena's 90% working interest Curamhuele block. At El Trapial, Chevron is drilling and testing four exploration wells in 2014 to further assess the unconventional shale potential. Others, such as YPF are also drilling on lands offsetting Madalena's Curamhuele block for unconventional shale and tight sand plays.
- The primary zones of interest across the Curamhuele block are the unconventional Vaca Muerta shale, Lower Agrio shale and liquids rich Mulichinco sands. The block is also prospective for other conventional reservoirs.
- To satisfy a portion of the 2014 block commitments, Madalena has recently shot an approximately 75 square kilometer 3D seismic survey at Curamhuele. Processing of this data is currently underway. The Company plans to merge this newly acquired data with the existing 125 square kilometer 3D survey on the block. This will provide 3D seismic coverage on the entire northern portion of the Curamhuele block.
- To satisfy the remaining 2014 block commitments, Madalena plans to execute two high impact re-entries of the Yp.x-1001 and Ch.x-1 wellbores. Through these re-entries, Madalena plans to test an estimated 200 meter thick tight Mulichinco sand liquids-rich gas play and an estimated 225 meter thick oil zone in the Lower Agrio shale (which is a second emerging unconventional shale play in Argentina). In response to offsetting industry activity, Madalena is also evaluating the Vaca Muerta shale across the block.
- The Company continues to examine opportunities in respect of a possible a joint venture or other transaction to accelerate exploration and development activities on the block. RBC Capital Markets, Madalena's exclusive advisor to its Neuquén basin assets, is in communication with a broad spectrum of parties to solicit interest in a joint venture or other transaction with the Company.

***Cortadera Block***

- On January 15, 2014, the Corporation announced that, on the Cortadera Block, the joint venture partnership consisting of Apache Corporation, Gas y Petroleo del Neuquén SA and Madalena had signed an amended contract agreement to formalize a multi-year extension of the initial exploration period and inclusion of subsequent exploration periods. Subsequent to that agreement and following an application and approval process, the first exploration period for Cortadera was extended by way of an official decree which was signed by the Province of Neuquén in Argentina. This extension provides the partnership until October 26, 2014 to satisfy the remaining work commitments on the block, which involves an upcoming re-entry of the CorS.x-1 well. Under the amended agreement, and subsequent to conducting the upcoming re-entry work, the partnership at Cortadera has the option to enter into a second exploration period extending to October 25, 2018 and a third exploration period extending to October 25, 2021, or extend the Cortadera Block through potential further evaluation and/or exploitation phases.

- Madalena and its new block partner YPF S.A. (acquired through YPF's recent purchase of the Apache subsidiary in Argentina) plan to re-enter the previously drilled CorS.x-1 Vaca Muerta test well to evaluate the uphole Mulichinco tight sand play (or other zone of interest). Madalena expects that its share of any costs for the work performed will not be significant due to YPF's continued earning obligations which include carrying Madalena for the majority of the anticipated costs.

**DOMESTIC OPERATIONS – *Greater Paddle River Area, Alberta, Canada***

- Domestically, Madalena's core area of operations is located in the greater Paddle River area, where the Company holds approximately 195 gross (153 net) sections of land (approximately 78% average working interest) in west-central Alberta that support light oil and liquids-rich gas resource plays. Madalena entered the domestic E&P space in November, 2012 and executed horizontal drilling activity in 2013 with a focus of bringing increased production and cash flow into the Company;
- Q1 – 2014 production from Madalena's Canadian based domestic assets was 833 boe/d. Due to the installation of pumping units on three of its four previously flowing producing oil wells, the Company experienced sjgnificant temporary downtime during the Quarter. All field work associated with the installation of these pumping units has now been completed and production has been restored and brought back online at these three locations. With these pumping units now in place, Madalena is better positioned to optimize its domestic production through the remainder of 2014.
- On April 1, 2014 Madalena placed its recently drilled Paddle River 12-31 horizontal Ostracod oil well (100% WI) on production. The IP30 of the well was 212 boe/d (75% oil and NGLs) which is consistent with management's expectations. As part of Madalana's inventory of horizontal Ostracod locations, the Company has a number of offsetting development locations to the 12-31 Ostracod well;
- Madalena's domestic focus is to exploit its inventory of horizontal development locations on its Ostracod oil, Notikewin/Wilrich liquids-rich gas and other emerging oil & liquids-rich gas resource plays in the area. Madalena also holds more than 100 net sections (100% W.I.) which are prospective for the Duvernay shale.

## FINANCIAL RESULTS

**Net Income (Loss) and Comprehensive Loss**

| Canadian $000s, except per share amounts | Three months ended March 31 **2014** | 2013 |
|---|---|---|
| Net income (loss) | **297** | (2,320) |
| Comprehensive income (loss) | **(6,283)** | (3,088) |
| Net loss Per share – basic & diluted | **0.00** | (0.01) |

The net income for the three months ended March 31, 2014 (the "Quarter") was $0.3 million (2013 – net loss $2.3 million). Increased revenue, foreign exchange gains, production and netbacks combined with lower general and administrative costs resulted in the Company recording net income during the Quarter.

The increase in the comprehensive loss compared to the net income was a result of the changes in the Argentine peso to Canadian dollar exchange rate applied to the net assets of the Company's operations in Argentina. The devaluation of the Argentine peso against the Canadian dollar is linked to Argentina's rate of inflation, which has been a persistent problem for several years, causing significant increases in the Company's cost of operations and capital expenditures. During 2013 the value of the Argentine peso declined by 19% against the Canadian dollar. During the three months ended March 31, 2014, the value of the Argentine peso declined an additional 15% and remained stable at an average exchange rate of 7.3 pesos to $Cdn since March 31, 2014.

**Production**

| **Average daily production** | Three months ended March 31 **2014** | 2013 |
|---|---|---|
| **Argentina** | | |
| Crude oil (Bbls/d) | **295** | 177 |
| Natural gas (Mcf/d) | **80** | 134 |
| Total daily production (boe/d) | **309** | 199 |
| **Canada** | | |
| Crude oil and condensate (Bbls/d) | **233** | 140 |
| Natural gas (Mcf/d) | **2,899** | 2,543 |
| Natural gas liquids (Bbls/d) | **116** | 109 |
| Total daily production (boe/d) | **833** | 673 |
| **Corporate** | | |
| Total daily production (boe/d) | **1,141** | 872 |
| % Oil & NGLs | **57%** | 49% |

*Neuquén Basin, Argentina*

The majority of Madalena's oil production was from the CAN.xr-2(h) well - approximately 62,500 barrels of oil were produced in Q1-2014 or 240 barrels of oil per day, net to Madalena. Both oil and gas production were negatively impacted during the Quarter by work-overs required on the CAN 3 and CAN 7 wells. Currently, neither is on stream as the CAN.xr-2(h) and the CAN-15(h) horizontal wells are being produced at restricted rates preferentially to the verticals, until further facility upgrades are completed in the field. Once further facility upgrades are completed, all behind pipe and restricted volumes will be brought on-stream.

*Canada*

The Company had 12 (7.5 net) producing oil wells and 24 (17.5 net) producing gas wells as at March 31, 2014. Production during the Quarter increased 24% to 883 boe/d (42% Oil & NGLs) from 673 boe/d (37% Oil & NGLs) in Q1 – 2013. Production was lower, when compared to Q4-2013 (883 boe/d versus 1,098 boe/d) as downtime was experienced when pumping units were installed on three of the four Ostracod oil wells during the Quarter.

**Average Realized Prices**

| Canadian $ | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Crude oil – $/bbl | **85.31** | 81.48 |
| Natural gas – $/mcf | **4.60** | 4.07 |
| Total – $/boe | **82.82** | 75.06 |
| **Canada** | | |
| Crude oil and condensate – $/bbl | **84.66** | 75.04 |
| Natural gas – $/mcf | **5.81** | 3.24 |
| Natural gas liquids – $/bbl | **66.43** | 58.79 |
| Total - $/boe | **53.44** | 37.40 |

The Company has the following physical natural gas and oil contracts in place:

| Type | Period | Volume | Price Floor | Price Ceiling | Index |
|---|---|---|---|---|---|
| Natural gas fixed | April 1, 2014 to Oct. 31, 2014 | 500 GJ/d | $3.45 CDN | $3.45 CDN | AECO |
| Natural gas fixed | April 1, 2014 to Oct. 31, 2014 | 300 GJ/d | $3.55 CDN | $3.55 CDN | AECO |
| Natural gas fixed | April 1, 2014 to Oct. 31, 2014 | 300 GJ/d | $4.43CDN | $4.43 CDN | AECO |
| Natural gas fixed | April 1, 2014 to Oct. 31, 2014 | 300 GJ/d | $4.52CDN | $4.52 CDN | AECO |
| | | | | | |
| Crude oil call options | Jan. 1, 2014 to Dec. 31, 2014 | 50 bbl/d | - | $100.00 US | WTI |
| Crude oil call options | Jan. 1, 2014 to Dec. 31, 2014 | 50 bbl/d | - | $100.00 US | WTI |
| Crude oil call options | Jan 1, 2015 to Dec. 31, 2015 | 50 bbl/d | - | $95.00 US | WTI |
| | | | | | |
| Crude Oil Swaps | Feb 1, 2014 to Dec. 31, 2014 | 50 bbl/d | - | $100 CDN | WTI |

The fair value of commodity contracts is determined by discounting the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted petroleum and natural gas volumes. The fair value of commodity contracts as at March 31, 2014 was a net payable and an unrealized loss of $351,857 (2013 - $65,114). Realized losses for the Quarter were $17,931 (2013 – nil) and are included in interest and other income on the Statement of Income (Loss) and Comprehensive Loss. The commodity contracts are classified as level 2 within the fair value hierarchy.

### Revenue

| Canadian $000s, except per boe | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Crude oil | **2,267** | 1,295 |
| Natural gas | **33** | 49 |
| | **2,300** | 1,344 |
| **Canada** | | |
| Crude oil and condensate | **1,778** | 945 |
| Natural gas | **1,532** | 742 |
| Natural gas liquids | **696** | 578 |
| | **4,006** | 2,265 |
| Corporate Total | **6,306** | 3,609 |
| Corporate - $/boe | **61.38** | 45.99 |

*Neuquén Basin, Argentina*
Oil sales increased by $1.0 million in the Quarter from the corresponding period in 2013 due to the new horizontal Sierras Blancas well (CAN.xr-2(h)) and prices realized from the sale of oil.

*Canada*
Oil sales increased by $0.8 million in the Quarter from the corresponding period in 2013 due to increased production and prices realized from the sale of oil. Natural gas sales increased by $0.8 million in the Quarter from the corresponding period in 2013 due to increased production and prices realized from the sale of gas.

### Royalties

| Canadian $000s | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Royalties | **330** | 209 |
| As % of revenue from Argentina | **14%** | 16% |
| **Canada** | | |
| Royalties | **434** | 316 |
| As % of revenue from Canada | **11%** | 14% |
| **Corporate total** | **764** | 525 |

*Neuquén Basin, Argentina*
Royalty expense in the Quarter increased as a result of higher production volumes.

*Canada*
Royalty expense consists of royalties paid to provincial governments, freehold landowners and overriding royalty owners. For the Quarter, royalties were 11% of revenues (2013 – 14%) of revenues. The decreased royalty rate in the Quarter was a result of the Company drilling wells eligible for a reduced crown royalty rate of 5%. Horizontal oil wells receive a maximum royalty rate of 5% with volume and production month limits set according to the

depth of the well (including the horizontal distance).

**Operating Costs**

| Canadian $000s, except per boe | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Operating costs | **851** | 687 |
| $/boe | **30.65** | 38.35 |
| **Canada** | | |
| Operating costs | **1,649** | 1,191 |
| $/boe | **22.00** | 19.66 |
| **Corporate total** | **2,500** | 1,878 |

*Neuquén Basin, Argentina*

Operating costs in Argentina were $30.65 per boe in the Quarter compared to $38.35 in Q1-2013 as the benefits from the optimization of surface fluid handling and gas conservation facilities were realized. Madalena expects to see future operating costs in Argentina decrease on a boe basis as the Company executes its multi-well horizontal program to increase oil volumes and overall facility throughput on newly up-graded and constructed infrastructure.

*Canada*

In Canada, operating costs were $22.00 per boe during the Quarter, compared to $19.66 in Q1-2013.

**Netbacks** (1)

| Canadian $ | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Revenue | **82.82** | 75.06 |
| Royalties | **(11.89)** | (11.69) |
| Operating expenses | **(30.65)** | (38.35) |
| Netbacks | **40.28** | 25.02 |
| **Canada** | | |
| Revenue | **53.44** | 37.40 |
| Royalties | **(5.78)** | (5.22) |
| Operating expenses | **(22.00)** | (19.66) |
| Netbacks | **25.66** | 12.52 |
| **Corporate** | | |
| Revenue | **61.38** | 45.99 |
| Royalties | **(7.43)** | (6.70) |
| Operating expenses | **(24.33)** | (23.93) |
| Netbacks | **29.61** | 15.37 |

(1) The term "netback" is a non-GAAP measure and may not be comparable with the calculation of other entities. Netback is calculated as the average unit sales price, less royalties and operating expenses and represents the cash margin for every barrel of oil

equivalent sold. The Company uses this measure to analyze operating performance and considers netback a key measure as it demonstrates its profitability relative to current commodity prices.

**General and Administration ("G&A") Expenses**

| Canadian $000s | Three months ended March 31 2014 | 2013 |
|---|---|---|
| Argentina | **432** | 439 |
| Canada | **664** | 1,626 |
| | **1,096** | 2,065 |

Canadian general and administrative costs for the quarter were lower than the comparable period in 2013 as a result of severance payments paid to a former officer in 2013.

**Finance Cost**

In Argentina, accretion costs were $18,000 (2013 – $20,000) for the Quarter. In Canada, accretion costs were $29,000 (2013 - $17,000) for the Quarter.

**Share-based Compensation**

The Company has issued Stock Options as incentive programs that allow officers, directors, consultants and employees to purchase shares in the Company.

Share based compensation was $349,000 in the Quarter (2013 - $150,000).

**Depletion and Depreciation**

| Canadian $000s | Three months ended March 31 2014 | 2013 |
|---|---|---|
| Argentina | **910** | 518 |
| Canada | **1,008** | 747 |
| | **1,918** | 1,264 |
| $/boe | **18.67** | 16.12 |

*Neuquén Basin, Argentina*
In Argentina, depletion and depreciation expense for the Quarter increased by $0.4 million from the same period last year due to higher depletion rates and production volumes.

*Canada*
In Canada, depletion and depreciation expense for the Quarter increased from the same period last year due to higher production volumes.

**Transactions with Related Parties**

A director of the Company is a partner of a law firm that provides legal services to the Company. During the Quarter, the Company incurred fees of $92,900 (2013 - $195,000) from this firm for legal fees related to legal matters of which $7,900 is included in accounts payable and accrued liabilities at March 31, 2014.

**Property, Plant & Equipment Additions**

| Canadian $000s | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Land | - | - |
| Geological and geophysical | - | 2 |
| Drilling and completions | 3,186 | 976 |
| Other | 194 | 388 |
| Argentina Total | 3,380 | 1,366 |
| | | |
| **Canada** | | |
| Land | - | - |
| Geological and geophysical | 6 | - |
| Drilling and completions | 100 | 7,492 |
| Well equipment and facilities | 255 | 1,025 |
| Other | 3 | 94 |
| Canada total | 365 | 8,611 |
| | | |
| **Corporate total** | 3,744 | 9,977 |

For the Quarter, capital expenditures for property plant and equipment were $3.7 million (2013 - $10.0 million). In Argentina to date in 2014, the Company participated (35% working interest) in the drilling of CAN 15(h).

Canadian activity during the Quarter included ongoing facility work at Leaman.

**Exploration and Evaluation Asset Additions**

| Canadian $000s | Three months ended March 31 2014 | 2013 |
|---|---|---|
| **Argentina** | | |
| Land acquisitions | **15** | 3 |
| Geological and geophysical | **1,697** | 5 |
| Drilling and completions | **1,141** | 806 |
| Well equipment and facilities | **68** | 139 |
| Other | **693** | (60) |
| Argentina Total | **3,614** | 893 |
| | | |
| **Canada** | | |
| Land acquisitions | **22** | 67 |
| Geological and geophysical | **1** | |
| Drilling and completions | **3,606** | 5,627 |
| Well equipment and facilities | **1,514** | 371 |
| Other | **48** | 40 |
| Canada total | **5,190** | 6,105 |
| | | |
| **Corporate total** | **8,804** | 6,998 |

Capital expenditures for exploration and evaluation assets were $8.8 million for the Quarter compared to $7.0 million for the corresponding period in 2013. Argentine expenditures were $3.6 million (2013 -$0.9 million) for the Quarter. Canadian expenditures were $5.2 million (2013 -$6.1 million) for the Quarter.

In Argentina, activity during the Quarter included the drilling and casing of the CAS.x-15 vertical well and the shooting of a 75 square km 3D seismic program at Curamhuele.

During the Quarter, Canadian activity included expenditures related to the Paddle River 12-31 horizontal Ostracod oil well (100% WI) well that was drilled in December, completed and equipped in the Quarter and put on-stream on April 1, 2014. The costs incurred in 2013 and 2014 to drill, complete, equip and the tie-in this well of approximately $4.3 million will be transferred to property, plant and equipment effective April 1, 2014.

In late 2013, the Company commenced the drilling of a horizontal step-out Ostracod well, incurring approximately $1.4 million of expenditures by year-end. During the Quarter, the Company incurred approximately $2 million to finish the drilling and subsequently complete the well. The Company evaluated the toe portion of the horizontal leg during the 2013 year-end financial reporting process and concluded that this portion of the well will not be productive. The associated costs of $1.4 million were included in the impairment charge for the year ended December 31, 2013. The Company will evaluate the heel portion of this well after break-up and depending on the outcome of this evaluation, a transfer to PP&E, an additional impairment charge, or a combination of the two, will be undertaken.

The remaining costs were incurred on two wells abandoned during the first quarter of 2014, resulting in an impairment charge of $658,000 (December 31, 2013 – $14.7 million).

**FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES**

Liquidity, working capital and shareholders' equity

| Canadian $000s | March 31 2014 | December 31 2013 |
|---|---|---|
| Working capital | **19,463** | 8,016 |
| Shareholders' equity | **94,350** | 79,003 |

The Company's capital management objective is to have sufficient capital to be able to execute its business plan. The Company manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying oil and natural gas assets. The Company considers its capital structure to include shareholders' equity, loans and borrowings and working capital. The Company may issue shares or enter into joint venture partnerships to fund its capital commitments.

At March 31, 2014, the Company had a revolving operating demand loan credit facility with the National Bank of Canada to a maximum of $10 million with interest charged at the bank's prime rate plus 1.0% per annum. Security for this facility is provided by way of a charge over the petroleum and natural gas assets of the Company. The facility includes a working capital ratio covenant, whereby the Company's working capital deficiency (excluding any unrealized hedging gains or losses) may not exceed $10 million. Standby fees associated with the facility are 0.25% per annum on the undrawn portion.

In addition, The Company has an acquisition / development demand loan credit facility with the National Bank of Canada to a maximum of $3 million with interest charged at the bank's prime rate plus 1.5% per annum.

Both facilities are subject to a periodic review by the bank and the next review is currently underway. The facilities were unutilized at March 31, 2014.

As the credit facilities are a demand loan, it may be called at any time. Accordingly, there is no assurance that the credit facilities will be renewed when the current scheduled review is completed.

**Share capital issued and options granted**

*Outstanding Share Capital*

During the Quarter, the Company issued 32,857,225 common shares at a price of $0.70 per common share, including 4,285,725 common shares issued pursuant to the exercise of the over-allotment option in full by the Underwriters, for aggregate gross proceeds of $23.0 million.

**Financial Instruments**

Other than the commodity contracts discussed earlier in this report, the Company's financial instruments comprise cash and cash equivalents, trade and other receivables, and trade and other payables. Carrying values reflect the current fair value of the Company's financial instruments due to their short-term to maturity.

**Decommissioning Obligations**

Decommissioning obligations result from net ownership interests in property, plant and equipment and are a critical accounting estimate. There are significant uncertainties related to settling decommissioning obligations and the impact on the financial statements could be material. The eventual timing of and costs to settle these obligations could differ from current estimates. The main factors that can cause expected decommissioning obligations to change are changes to laws and regulations, construction of new facilities, changes in reserve estimates and reserve lives and changes in technology.

*Argentina*
The total undiscounted amount of cash flows required to settle its decommissioning obligations is approximately $1.7 million. The majority of the costs are expected to be incurred between 2023 and 2025. An inflation rate of 10.9% was used to calculate the future value of the undiscounted decommissioning obligations. At March 31, 2014, the decommissioning obligations of $0.4 million have been discounted using a discount rate of 19.53%.

*Canada*
The total undiscounted amount of cash flows required to settle its decommissioning obligations is approximately $6.6 million. The majority of the costs are expected to be incurred between 2018 and 2030. An inflation rate of 2% was used to calculate the future value of the undiscounted decommissioning obligations. At March 31, 2014, the decommissioning obligations of $4.5 million have been discounted using a discount rate ranging up to 2.81%.

**Contractual Obligations**

*Development & Exploration commitments*

<u>Coiron Amargo Block</u>
The Coiron Amargo block is divided into two regions called Coiron Amargo Norte (northern portion of the block) and Coiron Amargo Sur (southern portion of the block). Coiron Amargo Norte is currently held under a 25 year exploitation (development) concession which was approved by the Province of Neuquén in 2012.

In October 2013, following an application and approval process by Madalena and its partners, the exploration period for Coiron Amargo Sur was extended until November 8, 2014 by way of an official decree signed by the Province of Neuquén in Argentina. The remaining work commitments in Coiron Amargo Sur are the drilling of one exploration well, estimated at approximately USD $1.94 million plus VAT (net to Madalena) as of March 31, 2013. After satisfying these remaining work commitments, Madalena has the ability to extend Coiron Amargo Sur through further exploration, evaluation and/or exploitation (development) phases.

*Curamhuele Block*

In June 2013 the exploration period was extended until November 8, 2014by way of an official decree signed by the Province of Neuquén.

The key zones of interest across the Curamhuele block are the unconventional Vaca Muerta shale, Lower Agrio shale and Mulichinco liquids rich tight gas sand, as well as other conventional formations of interest. The Company continues to examine opportunities in respect of a possible a joint venture or other transaction to accelerate exploration and development activities on the block. RBC Capital Markets, Madalena's exclusive advisor to its Neuquén basin assets, is in communication with a broad spectrum of parties to solicit interest in a joint venture or other transaction with the Company.

Madalena’s remaining share of future work commitments associated with the Curamhuele block as of March 31, 2014 is approximately US$12.3 million plus VAT. After satisfying these remaining work commitments, Madalena expects to either convert certain portions of the acreage into an exploitation (development) concession and/or enter into a new exploration period(s) or unconventional evaluation phase, to further explore and appraise the Curamhuele block.

*Cortadera Block*

On January 15, 2014, the Corporation announced that, on the Cortadera Block, the joint venture partnership consisting of Apache Corporation, Gas y Petroleo del Neuquén SA and Madalena had signed an amended contract agreement to formalize a multi-year extension of the initial exploration period and the option for subsequent exploration periods. Subsequent to that agreement and following an application and approval process, the first exploration period for Cortadera was extended by way of an official decree which was signed by the Province of Neuquén in Argentina. This extension provides the partnership until October 26, 2014 to satisfy the remaining work commitments on the block, which involves the upcoming re-entry work.

Under the amended agreement, and subsequent to conducting the upcoming re-entry work, the partnership at Cortadera has the option to enter into subsequent exploration periods involving a second exploration period extending to October 25, 2018 and potentially a third exploration period extending to October 25, 2021, or extend the Cortadera Block through potential further evaluation and/or exploitation phases.

The decree signed by the Province of Neuquén, as noted above, stipulates that Gas y Petroleo del Neuquén SA, which is the provincial petroleum company within the Province of Neuquén and is a working interest partner in the Cortadera Block, upwardly revised its carried working interest in the block to 15% from the previous 10%, resulting in a proportionate reduction of Madalena's working interest in the block to 37.8% compared to its previous 40% working interest.

Madalena and its new incoming partner (YPF S.A. through their purchase of the Apache subsidiary in Argentina) plan to re-enter the previously drilled CorS.x-1 Vaca Muerta test well to evaluate an up-hole zone of interest in the wellbore targeting the Mulichinco tight sand play. Madalena believes that its share of any work performed is not expected to be significant due to Apache’s (YPF S.A.) obligation to pay for the majority of the costs of the anticipated work program.

*Flow-through Shares Commitments*

During 2013, the Company completed a CEE flow through share financing in the amount of $5.7 million. As at March 31, 2014, $1.9 million of the CEE flow-through funds had been expended. The Company has until December 31, 2014 to expend the remaining CEE flow through funds in the amount of $3.8 million on qualified expenditures.

## ANNUAL AND QUARTERLY FINANCIAL RESULTS

### Quarterly Financial Results

| Canadian $000s, except shares outstanding | Q1 2014 | Q4 2013 | Q3 2013 | Q2 2013 |
|---|---|---|---|---|
| Revenues | **6,306** | 5,633 | 4,840 | 3,877 |
| Net income (loss) | **245** | (20,527) | (118) | (320) |
| Shares outstanding – 000s | **396.8** | 364.0 | 338.7 | 316.8 |
| Net income (loss) per share – basic and diluted | **0.00** | (0.06) | (0.00) | (0.00) |

| | Q1 2013 | Q4 2012 | Q3 2012 | Q2 2012 |
|---|---|---|---|---|
| Revenues | 3,610 | 3,012 | 1,762 | 375 |
| Net loss | (2,320) | (5,075) | (916) | (1,848) |
| Shares outstanding (‘000s) | 316.1 | 314.3 | 314.3 | 314.3 |
| Net loss per share – basic and diluted | (0.01) | (0.02) | (0.0) | (0.01) |

Generally, the Company’s increase in revenues during the Quarter can be attributed to increasing oil production in both Argentina and Canada.

The Company recorded an impairment charge in Q4-2013 and Q4-2012 of $20.0 million and $2.5 million, respectively, impacting the net loss recognized of $20.5 million and $5.1 million in Q4-2013 and Q4-2012, respectively.

The Company issued 32.8 million shares during the Quarter for gross proceeds of $23.0 million.

## CRITICAL ACCOUNTING JUDGEMENTS, ESTIMATES AND ACCOUNTING POLICIES

For more details regarding the Company’s critical accounting judgments, estimates and accounting policies the following should be read in conjunction with the Company’s 2013 annual MD&A.

Management is required to make judgments, estimates and assumptions in the application of accounting policies that could have a significant impact on our financial results. Actual results may differ from those estimates and those differences may be material. The estimates and assumptions used are subject to updates based on experience and the application of new information. The Company’s critical accounting policies and estimates are reviewed annually by the Audit Committee of the Board. Further details on the basis of presentation and significant accounting policies can be found in the Company’s notes to the Consolidated Financial Statements and annual MD&A for the year ended December 31, 2013.

### Critical Accounting Judgments in Applying Accounting Policies

Critical judgments are those judgments made by Management in the process of applying accounting policies that have the most significant effect on the amounts recognized in the Company’s annual and interim Consolidated Financial Statements and accompanying notes. On January 1, 2014, as required, the Company adopted the amendments to IAS 32 and IFRIC 21. See discussion below under Changes in Accounting Policies for details. Further information on Management’s critical accounting judgments in applying accounting policies can be found in the notes to the Consolidated Financial Statements and annual MD&A for the year ended December 31, 2013.

## Critical accounting estimates

Critical accounting estimates are those estimates that require Management to make particularly subjective or complex judgments about matters that are inherently uncertain. Estimates and underlying assumptions are reviewed on an ongoing basis and any revisions to accounting estimates are recognized in the period in which the estimates are revised. For 2013, there have been no changes to the Company's key sources of estimation uncertainty. Further information on the Company's key sources of estimation uncertainty can be found in the notes to the Consolidated Financial Statements and annual MD&A for the year ended December 31, 2013.

## Changes in Accounting Policies

The IASB issued International Financial Reporting Interpretations Committee Interpretation ("IFRIC") 21, "Levies" which was adopted by the Company on January 1, 2014. The IFRIC clarifies that an entity should recognize a liability for a levy when the activity that triggers payment occurs. The adoption of this interpretation did not impact the Condensed Interim Consolidated Financial Statements.

Effective January 1, 2014, the Company adopted, as required, amendments to IAS 32, "Financial Instruments: Presentation" ("IAS 32"). The amendments clarify that the right to offset financial assets and liabilities must be available on the current date and cannot be contingent on a future event. IAS 32 did not impact the Condensed Interim Consolidated Financial Statements.

## Future Accounting Pronouncements

There were no new or amended standards issued during the three months ended March 31, 2014 that are applicable to the Company in future periods. A description of standards and interpretations that will be adopted by the Company in future periods can be found in the notes to the annual Consolidated Financial Statements and MD&A for the year ended December 31, 2013.

# RISK MANAGEMENT

For a full understanding of the risks that impact the Company, the following discussion should be read in conjunction with the Company's 2013 annual MD&A.

The Company is exposed to a number of risks through the pursuit of its strategic objectives. Some of these risks impact the oil and gas industry as a whole and others are unique to its operations. Actively managing these risks improves the Company's ability to effectively execute its business strategy. The Company's exposure to liquidity risk, safety risk, capital project execution and operating risk, reserves replacement risk, environmental risk and regulatory risk has not changed substantially since December 31, 2013. For a further and more in-depth discussion of our risk management see the Company's annual MD&A for the year ended December 31, 2013.

A description of the risk factors and uncertainties affecting the Company can be found in the Advisory and a full discussion of the material risk factors affecting the Company can be found in our Annual Information Form for the year ended December 31, 2013.

# ADVISORY

## Forward Looking Statements

This MD&A may include forward-looking statements including opinions, assumptions, estimates and management's assessment of future plans and operations, expected depletion, depreciation and accretion expenses, expectations as to the taxability of the Company and planned capital expenditures and the timing and funding thereof. When used in this document, the words "anticipate," "believe," "estimate," "expect," "intent," "may," "project," "plan", "should" and similar expressions are intended to be among the statements that identify forward-looking statements. Forward-looking statements are subject to a wide range of risks and uncertainties, and although the Company believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will be realized. Any number of important factors could cause actual results to differ materially from those in the forward-looking statements including, but not limited to, risks associated with petroleum and natural gas exploration, development, exploitation, production, marketing and transportation, the volatility of petroleum and natural gas prices, currency fluctuations, the ability to implement corporate strategies, the state of domestic capital markets, the ability to obtain financing, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, changes in petroleum and natural gas acquisition and drilling programs, delays resulting from inability to obtain required regulatory approvals, delays resulting from inability to obtain drilling rigs and other services, labour supply risks, environmental risks, competition from other producers, imprecision of reserve estimates, changes in general economic conditions, ability to execute farm-in and farm-out opportunities, and other factors, all of which are more fully described from time to time in the reports and filings made by the Company with securities regulatory authorities.

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

The forward looking statements contained in this MD&A are expressly qualified by this cautionary statement. Readers are cautioned not to place undue reliance on forward-looking statements, as no assurances can be given as to future results, levels of activity or achievements. Except as required by applicable securities laws, the Company does not undertake any obligation to publicly update or revise any forward-looking statements.

**Reserves and Other Oil and Gas Disclosure**

Any references in this news release to test rates, flow rates, initial and/or final raw test or production rates, early production, test volumes behind pipe and/or "flush" production rates are useful in confirming the presence of hydrocarbons, however, such rates are not necessarily indicative of long-term performance or of ultimate recovery. Such rates may also include recovered "load" fluids used in well completion stimulation. Readers are cautioned not to place reliance on such rates in calculating the aggregate production for Madalena. In addition, the Vaca Muerta shale is an unconventional resource play which may be subject to high initial decline rates.

**Numerical Amounts**

The reporting and the measurement currency is the Canadian dollar. Natural gas reserves and volumes are converted to barrels of oil equivalent (boe) on the basis of six thousand cubic feet (mcf) of gas to one barrel (bbl) of oil. Boe’s may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf to 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

This MD&A uses the term “netback” which is a term that does not have standardized meanings under GAAP and this non-GAAP measurement may not be comparable with the calculation of other entities. The Company uses this measure to analyze operating performance.

The term “netback”, which is calculated as the average unit sales price, less royalties and operating expenses, represents the cash margin for every barrel of oil equivalent sold. The Company considers this a key measure as it demonstrates its profitability relative to current commodity prices. This term does not have any standardized meaning prescribed by GAAP and, therefore, might not be comparable with the calculation of a similar measure for other companies.

## ABBREVIATIONS

The following is a summary of the abbreviations used in this MD&A:

**Oil and Natural Gas Liquids**

| | |
|---|---|
| Bbl | barrel |
| Bbls/d | barrels per day |
| NGLs | Natural gas liquids |
| boe | barrel of oil equivalent |
| boe/d | barrel of oil equivalent per day |

**Natural Gas**

| | |
|---|---|
| Mcf | thousand cubic feet |