REPORT TO SHAREHOLDERS

Castor Underground Gas Storage (Castor Project)

We are very pleased to inform the shareholders that 2012 saw the successful completion of the construction phase of the Castor Project. In July 2012, following a seamless testing and commissioning protocol, the Castor Project was granted the *provisional commissioning certificate* by the relevant Spanish regulatory authorities, a key requirement for the project, signifying that the facility is ready for service and ready for the injection of 600 million cubic metres of cushion gas.

In accordance with new regulations relating to the investment in cushion gas, Escal UGS SL ("Escal") (the owner of the Castor Exploitation Concession) has reached agreement with Enagas S.A. ("Enagas"), the leading gas transporter in Spain, to provide the 600 million cubic metres of cushion gas for injection. It is now anticipated that injection will commence early June 2013 and take approximately four months, subject to Enagas' procurement program. Following the completion of the injection process, the Castor facility will be required to undergo a 48 hour performance test before becoming operational within the Spanish gas system.

The Project has been delayed by almost a year as a consequence of certain regulatory changes introduced by the Spanish Government in April 2012. These negatively affected the economic parameters of the Castor Project at a critical juncture, and caused issues with the project financing leading the lenders to suspend further draws of approximately €270 million against the €1.3 billion line of credit. In the intervening months, Escal and its shareholders worked cooperatively with the Spanish authorities to ensure the economic viability of the Castor Project. Finally, at the end of the year, the Spanish authorities issued further regulatory changes which were acceptable to the owners and to the lenders of the project, now enabling the project to proceed to full operational status.

For ease of reference, a summary of the new regulations affecting the remuneration of the underground gas storage sector as they affect the Castor Project are attached to this report.

Foremost now is the question of when remuneration will start flowing for the Castor Project. As stipulated in the new regulations, the capital investment period for the Castor Project ended on July 5, 2012, at which date the total investment amounted to €1.46 billion, including interest paid during construction. It is important to note that the amount invested in the project for remuneration purposes is subject to economic and technical review by the regulatory authorities and will only be finalized when that process is completed. Previous regulations had provided for remuneration payments to be made to underground gas projects as advances against final remuneration in order to mitigate the impact of timing gaps resulting from the approval process. This facility has been eliminated in the new regulations and in the case of Castor, after it had received €111 million. Instead, the new regulations provide for approval of identifiable components of a Castor Project so that parts of the total investment can start receiving remuneration pending final determination. Importantly, in the case of Castor, the remuneration will start accruing as of July 5, 2012, the date of the *provisional commissioning certificate*. It is anticipated, but not certain, that some remuneration will be received in 2013 on account of 2012.

The negative change in Spain's regulations governing the energy sector was an unfortunate reaction to Spain's debt crisis which in turn was part of the larger European economic and banking crisis. Investor and lender confidence is easily shaken by adverse change of regulations. Fortunately, the Spanish authorities recognize the high strategic importance of the Castor Project given that the facility is capable of delivering gas at high rates, up to 25 million cubic metres per day, achievable due to the high quality of the reservoir rock and the existence of a large underlying aquifer that maintains the reservoir pressure at a constant level. Spain continues to be exposed to interruptions in gas supplies due to the exclusive reliance on imports, a significant portion of which are from Algeria. In order to retain investor and lender confidence, the regulations now provide owners of gas storage exploitation concessions the right to relinquish a concession, with compensation, at any time during 25 years from the date the concession was granted, which in the case of Castor was June 2008. As a result of the positive regulatory changes introduced in December 2012, Escal and its lenders are in the process of finalizing an agreement with respect to the €1.3 billion debt facility, whereby the balance of the facility will be made available.

Southern Ontario Oil and Gas Assets

During 2012, the Corporation produced a daily average of 10 MMcf mostly from its 65% working interest in offshore gas wells in Lake Erie, and approximately 700 Bbls of light oil and condensate from its adjacent onshore oil wells where it holds approximately a 90% working interest. Revenues, before royalty interests were $35.9 million, representing an average price of $3.18/Mcf on sales of natural gas (down from $4.50 in 2011) and an average price of $88.19/bbl on sales of crude oil and liquids. Despite the low level of gas prices in 2012, the Corporation achieved an operating netback, after payment of royalties and operating costs, of $1.60/Mcf. For oil production, the operating netback was $54.83/bbl relative to the average price of $88.19/bbl.

The year 2012 saw a continuing weakness in Canadian natural gas prices which severely curtailed the cash flows of the natural gas producers. In addition, the Canadian oil production received prices well below international prices, due to excess regional supply. Internationally, oil prices remained stable in 2012, with the West Texas Intermediate price averaging US$94.06, just marginally below an average price of US$94.91 in 2011. The Edmonton Par price however, responding to excess supply, fell to an average of $86.57/bbl in 2012 compared with $95.57/bbl in 2011. The gas production from Lake Erie properties attracts a premium due to proximity to the Greater Toronto market and we will take opportunities to hedge oil and gas prices when opportunities arise. For the balance of 2013, gas production of 6.3 Mmcf/day has been hedged at $4.07 per mbtu and oil production of 500 Bbls/day at $98.22 per barrel.

In an environment of low natural gas prices, the Corporation intends to direct its 2013 capital program of approximately $13.2 million primarily towards increasing light oil production and reserves from existing pools and drilling exploration wells to evaluate new horizons in southern Ontario that have geological potential yet are virtually untapped. The exploration program will include the acquisition of new seismic. The funding of the 2013 program will be met through internally generated cash flows, and through a fully subscribed Rights Issue whereby the Corporation issued 23,521,663 (of which 17,787,596 were on a "flow-through" basis) for a aggregate consideration of approximately $8.9 million. The 'flow through' funds will be used primarily to drill exploratory oil prospects. A new onshore drilling rig was purchased in 2012 for approximately $3.6 million in order to drill more efficiently, to lower the cost of drilling, and to increase the safety involved in drilling operations.

At December 31, 2012, the reserve report from the independent evaluator estimates the Corporation's proved and probable working interest reserves at 82,067 MMcf of natural gas and 2,681 Mbbl of oil and liquids, with a working interest reserve life index based on proved reserves of 18.9 years on natural gas and 6.5 years for oil and liquids.

We look forward to further demonstrating the potential of the Ontario assets in 2012, and to the Castor Project commencement of commercial gas storage operations.

We would like to thank Dundee Energy's shareholders and Board of Directors for their support, and our dedicated field operations staff in Ontario for another year of safe, efficient and profitable operations.

Ned Goodman
Chairman of the Board

Jaffar Khan
President & CEO

May 2013

For further information you may refer to the Corporation's management's discussion and analysis for the year ended December 31, 2012 which can be viewed on the System for Electronic Document Analysis and Retrieval at www.sedar.com or the Corporation's website at www.dundee-energy.com.

Summary of Remuneration Scheme for Underground Gas Storage Projects in Spain

(i) **Return of Investment:** Investment will be amortized in equal annual parts over 20 years, commencing from the date of the *provisional commissioning certificate* (July 6, 2012 for Castor). The unamortized investment balance will be adjusted upwards annually by a factor of 2.5%. Annual remuneration, subsequent to the 20 year period until the expiry of the exploitation concession, will be equal to 50% of the amount earned in the 20th year, including the return on investment (described below).

(ii) **Return on Investment:** Unamortized investment will earn an annual rate equal to the average 10 year Spanish Government Bond rate over the 24 months preceding the date of the *provisional commissioning certificate* plus 350 basis points. For Castor, the rate of return has been established at 8.76%.

(iii) **Operating Costs:** These will be reimbursed based on direct and indirect costs, on a monthly basis, and will be adjusted for inflation. Costs are subject to audit and final adjustment.

(iv) **Payment of Remuneration:** Remuneration paid in any calendar year will be for the amount accrued in the previous calendar year. Payments will be made on a monthly basis on account of the final annual remuneration.

(v) **Relinquishment of a Concession:** The right to relinquish a concession, with compensation, has been extended to 25 years from the date of grant of the concession (June 6, 2008 for Castor Project).

(vi) **Cushion Gas:** Regulations provide for the separation of the ownership of cushion gas from the ownership of the storage facility, allowing for a third party to provide the cushion gas and receive the corresponding remuneration directly.

(vii) **Provisional Remuneration:** This facility was available under previous regulations to provide advances during the construction phase against final remuneration, and which has now been terminated. Castor Project received €111 million under this facility. This amount will be deducted from the remuneration to be received over the 20 year period.

(viii) **Inclusion in the Remuneration Scheme:** Commencement of remuneration is subject to a financial and technical audit, to be conducted by an independent qualified person at which time the definitive remuneration base will be established. However, the regulations provide for partial inclusions in the definitive remuneration scheme by the approval by segments representing major constituent parts of a project and the related investment. This provision is designed to provide owners with cash flow prior to the completion of the overall process.