

CANARGO ENERGY CORP

Form 10-Q

November 09, 2006

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006  
OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_  
Commission File Number 0001-32145  
**CANARGO ENERGY CORPORATION**  
(Exact name of registrant as specified in its charter)**

Delaware

91-0881481

(State or other jurisdiction of  
Incorporation or organization)

(I.R.S. Employer Identification No.)

CanArgo Energy Corporation  
P.O. Box 291, St. Peter Port, Guernsey, British Isles

GY1 3RR

(Address of principal executive offices)

(Zip Code)

(44) 1481 729 980

(Registrant's telephone number, including area code)

**(Former name, former address and former fiscal year, if changed since last report)**

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the **Exchange Act**) during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one)

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

The number of shares of registrant's common stock, par value \$0.10 per share, outstanding on November 1, 2006 was 237,132,390.

**CANARGO ENERGY CORPORATION  
FORM 10-Q  
TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART 1. FINANCIAL INFORMATION:</u></b>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Condensed Balance Sheets – unaudited</u>	4
<u>Consolidated Condensed Statements of Operations – unaudited</u>	5
<u>Consolidated Condensed Statements of Cash Flows – unaudited</u>	6
<u>Notes to Unaudited Consolidated Condensed Financial Statements</u>	7
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	32
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	46
<u>Item 4. Controls and Procedures</u>	46
<b><u>PART 2. OTHER INFORMATION:</u></b>	
<u>Item 1. Legal Proceedings</u>	49
<u>Item 1A. Risk Factors</u>	49
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	49
<u>Item 6. Exhibits</u>	
<u>(a) Exhibit Index</u>	50
<u>Signatures</u>	54
<u>EX-10.22: WAIVER, CONSENT AND AMENDMENT AGREEMENT</u>	
<u>EX-10.23: WAIVER, CONSENT AND AMENDMENT AGREEMENT</u>	
<u>EX-10.28: SERVICE CONTRACT</u>	
<u>EX-31.1: CERTIFICATION</u>	
<u>EX-31.2: CERTIFICATION</u>	
<u>EX-32: CERTIFICATION</u>	
Below is a list of terms that are common to our industry and used throughout this document:	
/d	= per day
Bbl	= barrels
Bbtu	= billion British thermal units
Bcf	= billion cubic feet
Bcfe	= billion cubic feet of natural gas equivalents
Bopd	= barrels of oil per day
MBbls	= thousand barrels
Mcf	= thousand cubic feet
Mcfe	= thousand cubic feet of natural gas equivalents
MCM	= thousand cubic metres
[MBtu]	= million British thermal units
[MMcf]	= million cubic feet

[MMcfe = million cubic feet of natural gas equivalents

MW = megawatt

GL = natural gas liquids

Btu = trillion British thermal units

When we refer to natural gas and oil in equivalents, we are doing so to compare quantities of oil with quantities of natural gas or to express these different commodities in a common unit. In calculating equivalents, we use a generally recognized standard in which one Bbl of oil is equal to six Mcf of natural gas. Also, when we refer to cubic feet measurements, all measurements are at a pressure of 14.73 pounds per square inch.

When we refer to us, we, our, ours, the Company, or CanArgo, we are describing CanArgo Energy Corporation or our subsidiaries.

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

*The United States Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements. Such forward-looking statements are based upon the current expectations of CanArgo and speak only as of the date made. These forward-looking statements involve risks, uncertainties and other factors. The factors discussed elsewhere in this Quarterly Report on Form 10-Q are among those factors that in some cases have affected CanArgo's historic results and could cause actual results in the future to differ significantly from the results anticipated in forward-looking statements made in this Quarterly Report on Form 10-Q, future filings by CanArgo with the Securities and Exchange Commission, in CanArgo's press releases and in oral statements made by authorized officers of CanArgo. When used in this Quarterly Report on Form 10-Q, the words estimate, project, anticipate, expect, intend, believe, hope, may and similar expressions, as well as will, shall and other indications of future tense, are intended to identify forward-looking statements. Few of the forward-looking statements in this Report deal with matters that are within our unilateral control. Acquisition, financing and other agreements and arrangements must be negotiated with independent third parties and, in some cases, must be approved by governmental agencies. These third parties generally have interests that do not coincide with ours and may conflict with our interests. Unless the third parties and we are able to compromise their various objectives in a mutually acceptable manner, agreements and arrangements will not be consummated.*

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****CANARGO ENERGY CORPORATION AND SUBSIDIARIES  
Consolidated Condensed Balance Sheets**

	<b>September 30, 2006</b>	December 31, 2005
	(Expressed in United States dollars)	
	<b>(Unaudited)</b>	(Audited)
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 17,333,598	\$ 18,540,558
Restricted cash	299,928	3,181,672
Accounts receivable	915,636	413,183
Crude oil inventory	416,822	886,250
Prepayments	5,229,532	4,375,855
Assets to be disposed	6,997	5,112
Assets held for sale	600,000	600,000
Other current assets	142,929	150,712
Total current assets	\$ 24,945,442	\$ 28,153,342
<b>Non Current Assets</b>		
Investments	154,073	
Accounts receivable	375,099	
Prepaid financing fees	471,664	246,910
Capital assets, net (including unevaluated amounts of \$59,600,917 and \$50,644,999, respectively)	138,590,595	119,048,049
<b>Total Assets</b>	<b>\$ 164,536,873</b>	<b>\$ 147,448,301</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Accounts payable trade	\$ 2,867,258	\$ 5,270,916
Loans payable		964,142
Accrued liabilities	7,102,689	6,356,623
Liabilities to be disposed	647,376	753,966
Total current liabilities	\$ 10,617,323	\$ 13,345,647
Long term debt	39,118,021	25,000,000
Other non current liabilities	1,847,742	1,001,041
Provision for future site restoration	589,718	253,000

<b>Total Liabilities</b>	<b>\$ 52,172,804</b>	<b>\$ 39,599,688</b>
Commitments and contingencies		
Temporary Equity	<b>\$ 3,899,080</b>	<b>\$ 2,119,530</b>
Stockholders' equity:		
Common stock, par value \$0.10; authorized - 375,000,000 shares at September 30, 2006 and 300,000,000 at December 31, 2005; shares issued, issuable and outstanding - 224,882,606 at September 30, 2006 and 222,586,867 at December 31, 2005	<b>22,488,259</b>	22,258,685
Capital in excess of par value	<b>217,060,531</b>	202,892,303
Deferred compensation expense		(2,220,399)
Accumulated deficit	<b>(131,083,801)</b>	(117,201,506)
Total stockholders' equity	<b>\$ 108,464,989</b>	<b>\$ 105,729,083</b>
<b>Total Liabilities, Temporary Equity and Stockholders' Equity</b>	<b>\$ 164,536,873</b>	<b>\$ 147,448,301</b>

The accompanying notes are an integral part of the Consolidated Condensed Financial Statements.

Table of Contents

**CANARGO ENERGY CORPORATION AND SUBSIDIARIES**  
**Consolidated Condensed Statements of Operations**

	Unaudited Three Months Ended		Unaudited Nine Months Ended	
	<b>September 30, 2006</b>	September 30, 2005	<b>September 30, 2006</b>	September 30, 2005
	(Expressed in United States dollars)			
Operating Revenues from Continuing Operations:				
Oil and gas sales	\$ 2,090,147	\$ 2,580,847	\$ 4,092,224	\$ 3,931,039
	<b>2,090,147</b>	2,580,847	<b>4,092,224</b>	3,931,039
Operating Expenses:				
Field operating expenses	446,010	756,309	1,340,169	1,328,343
Direct project costs	235,159	303,768	677,656	909,525
Selling, general and administrative	4,180,527	3,277,869	10,283,885	7,453,297
Depreciation, depletion and amortization	720,646	769,909	2,251,574	1,800,947
	<b>5,582,342</b>	5,107,855	<b>14,553,284</b>	11,492,112
<b>Operating Loss from Continuing Operations</b>	<b>(3,492,195)</b>	(2,527,008)	<b>(10,461,060)</b>	(7,561,073)
Other Income (Expense):				
Interest, net	(1,954,296)	(458,088)	(4,194,903)	(437,614)
Foreign exchange gains (losses)	(163,653)	(51,587)	220,800	(105,012)
Other	(89,819)	234,343	(210,551)	142,177
Equity Loss from investments				(155,016)
<b>Total Other Expense</b>	<b>(2,207,768)</b>	(275,332)	<b>(4,184,654)</b>	(555,465)
<b>Loss from Continuing Operations Before Taxes</b>	<b>(5,699,963)</b>	(2,802,340)	<b>(14,645,714)</b>	(8,116,538)
Income taxes				
<b>Loss from Continuing Operations</b>	<b>(5,699,963)</b>	(2,802,340)	<b>(14,645,714)</b>	(8,116,538)
<b>Net Income (Loss) from Discontinued Operations, net of taxes</b>	<b>(18,154)</b>	(139,590)	<b>763,419</b>	444,649



Edgar Filing: CANARGO ENERGY CORP - Form 10-Q

<b>Net Loss and Comprehensive Loss</b>	<b>\$ (5,718,117)</b>	<b>\$ (2,941,930)</b>	<b>\$ (13,882,295)</b>	<b>\$ (7,671,889)</b>
--	-----------------------	-----------------------	------------------------	-----------------------

Weighted average number of common shares outstanding

- Basic	<b>224,260,628</b>	221,485,695	<b>223,942,445</b>	207,880,022
---------	--------------------	-------------	--------------------	-------------

- Diluted	<b>224,260,628</b>	221,485,695	<b>223,942,445</b>	207,880,022
-----------	--------------------	-------------	--------------------	-------------

**Basic and Diluted Net Loss Per Common Share**

- from continuing operations	<b>\$ (0.03)</b>	\$ (0.01)	<b>\$ (0.07)</b>	\$ (0.04)
------------------------------	------------------	-----------	------------------	-----------

- from discontinued operations	<b>\$ (0.00)</b>	\$ (0.00)	<b>\$ 0.00</b>	\$ 0.00
--------------------------------	------------------	-----------	----------------	---------

**Basic and Diluted Net Loss Per Common Share**

	<b>\$ (0.03)</b>	\$ (0.01)	<b>\$ (0.06)</b>	\$ (0.04)
--	------------------	-----------	------------------	-----------

The accompanying notes are an integral part of the Consolidated Condensed Financial Statements.

**Table of Contents**

**CANARGO ENERGY CORPORATION AND SUBSIDIARIES**  
Consolidated Condensed Statements of Cash Flows

	Unaudited	
	<b>Nine Months Ended September</b>	
	<b>2006</b>	<b>2005</b>
	(Expressed in United States dollars)	
Operating activities:		
Loss from continuing operations	<b>(14,645,714)</b>	(8,116,538)
Adjustments to reconcile net loss from continuing operations to net cash used by operating activities:		
Non-cash stock compensation expense	<b>1,672,651</b>	1,762,890
Non-cash interest expense and amortization of debt discount	<b>3,363,463</b>	608,132
Common stock issued for services		53,600
Non-cash miscellaneous expenses		32,890
Depreciation, depletion and amortization	<b>2,251,574</b>	1,800,947
Equity loss (income) from investments		155,016
Allowance for doubtful accounts	<b>234,021</b>	155,686
Changes in assets and liabilities:		
Restricted cash	<b>2,881,744</b>	(1,755,269)
Cash Investments	<b>(154,073)</b>	
Accounts receivable	<b>(1,049,822)</b>	1,062,975
Inventory	<b>469,428</b>	(357,835)
Prepayments	<b>(66,186)</b>	37,000
Other current assets	<b>7,783</b>	(7,805)
Accounts payable	<b>(2,889,348)</b>	(785,137)
Deferred revenue		(3,044,321)
Accrued liabilities	<b>(455,115)</b>	696,477
<b>Net cash used by continuing operating activities</b>	<b>(8,379,593)</b>	(7,701,292)
Investing activities:		
Capital expenditures	<b>21,039,480</b>	(25,853,318)
Acquisitions, net of cash acquired		609,553
Change in non-cash working capital items	<b>(672,333)</b>	(395,514)
<b>Net cash used in investing activities</b>	<b>(21,711,813)</b>	(25,639,279)
Financing activities:		
Proceeds from sale of common stock	<b>527,349</b>	4,429,303
Share issue costs		(581,877)
Proceeds from loans	<b>28,000,000</b>	40,000,000
Repayment of loans		(7,200,000)
Deferred loan costs	<b>(297,846)</b>	(385,630)
<b>Net cash provided by financing activities</b>	<b>28,229,503</b>	36,261,796

Discontinued activities:		
Net cash generated by operating activities	<b>654,943</b>	(518,271)
Net cash used in investing activities		
Net cash provided by financing activities		
<b>Net cash flows from assets and liabilities held for sale and to be disposed</b>	<b>654,943</b>	(518,271)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(1,206,960)</b>	2,402,954
<b>Cash and cash equivalents, beginning of period</b>	<b>18,540,558</b>	24,617,047
<b>Cash and cash equivalents, end of period</b>	<b>\$ 17,333,598</b>	\$ 27,020,001

The accompanying notes are an integral part of the Consolidated Condensed Financial Statements.

**Table of Contents**

**CANARGO ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Unaudited Consolidated Condensed Financial Statements**

**1. Basis of Presentation**

The interim consolidated condensed financial statements and notes thereto of CanArgo Energy Corporation and its subsidiaries (collectively, we, our, CanArgo or the Company) have been prepared by management without audit pursuant to the rules and regulations of the U.S. Securities and Exchange Commission. In the opinion of management, the consolidated condensed financial statements include all adjustments, consisting of normal recurring adjustments, except the discontinued operations as explained in note 18, necessary for a fair statement of the results for the interim period. Although management believes that the disclosures are adequate to make the information presented not misleading, certain information and footnote disclosures, including a description of significant accounting policies normally included in the financial statements prepared in accordance with accounting principles generally accepted in the U.S., have been condensed or omitted pursuant to such rules and regulations. The accompanying consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in CanArgo's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission. All amounts are in U.S. dollars. The results of operations for interim periods are not necessarily indicative of the results for any subsequent quarter or the entire fiscal year ending December 31, 2006.

**Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**2 Dismantlement, Restoration and Environmental Costs**

Effective January 1, 2003, we recognize liabilities for asset retirement obligations associated with tangible long-lived assets, such as producing well sites, with a corresponding increase in the related long-lived asset. The asset retirement cost is depreciated along with the property and equipment in the full cost pool. The asset retirement obligation is recorded at fair value and accretion expense, recognized over the life of the property, increases the liability to its expected settlement value. If the fair value of the estimated asset retirement obligation changes, an adjustment is recorded for both the asset retirement obligation and the asset retirement cost. As at September 30, 2006 and December 31, 2005, the asset retirement obligation, which is included on the consolidated balance sheet in provision for future site restoration, was \$589,718 and \$253,000, respectively.

**3 Stock Based Compensation Plans**

Effective January 1, 2006 the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004), Share Based Payment (SFAS No. 123(R)). Generally, the fair value approach in SFAS No. 123(R) is similar to the fair value approach described in SFAS No. 123. In 2005, we used the Black-Scholes option pricing model to estimate the fair value of stock options granted to employees. We adopted SFAS No. 123(R), using the modified-prospective method, beginning January 1, 2006. We also elected to continue to estimate the fair value of stock options using the Black-Scholes-option pricing model. Total compensation cost related to non-vested awards not yet recognized was approximately \$1,672,651 as of September 30, 2006 and the weighted average period over which this cost will be recognized is approximately 4 months.

**Table of Contents****4 Foreign Operations**

Our current and future operations and earnings depend upon the results of our operations primarily in Georgia and to a lesser degree in the Republic of Kazakhstan ( Kazakhstan ). There can be no assurance that we will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on our financial position, results of operations and cash flows. Also, the success of our operations generally will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competition and changes in regulation. Since we are dependent on international operations, we will be subject to various additional political, economic and other uncertainties. Among other risks, our operations may be subject to the risks and restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and restrictive regulations.

**5 Restricted Cash**

In the first quarter of 2005 we funded a certificate of deposit in the amount of \$3,900,000 to secure the issuance of a letter of credit as required under the rig rental and drilling contract we entered into with Saipem, S.p.A. Under the terms of the letter of credit \$1,100,000 was released and became unrestricted cash in July 2005. The remaining deposit became unrestricted in August 2006.

In the third quarter of 2005, we deposited approximately \$300,000 to secure the issuance of a letter of credit as required under the drilling contract we entered into with Baker Hughes International. This deposit is due to become unrestricted in December 2006.

**6 Accounts Receivable**

Accounts receivable at September 30, 2006 and December 31, 2005 consisted of the following:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Current Assets		
Trade receivables before allowance for doubtful debts	\$ 1,252,847	\$ 919,512
Allowance for doubtful debts	(1,246,089)	(910,047)
Insurance receivable	813,646	31,755
Fees due from underwriters		180,000
Other receivables	95,232	191,963
	<b>\$ 915,636</b>	<b>\$ 413,183</b>
Non Current Assets		
Other receivables	\$ 375,099	\$
	<b>\$ 375,099</b>	<b>\$</b>

Bad debt expense for the nine month periods ended September 30, 2006 and 2005 was \$234,021 and \$155,686 respectively.

In September 2004, a blow-out occurred at the N100 well on the Ninotsminda Field. Our insurers will cover 80% of the costs associated with the blow out up to a maximum cover of \$2,500,000. We received \$800,000 from our insurers, in the second quarter of 2005 and a further \$560,000 in the third quarter of 2006, in respect of costs incurred to date. As of September 30, 2006 and December 31, 2005, \$338,981 and \$31,755 was recorded as a receivable, respectively. In the second quarter of 2006 we filed a claim with our insurance



**Table of Contents**

carrier for recovery of drilling equipment lost in the Manavi 12 well. As of September 30, 2006, \$474,665 was recorded as a receivable in connection with this claim.

Non current asset accounts receivables of \$375,099 at September 30, 2006 relate to VAT amounts recoverable from our Kazakhstan operations as an offset against VAT payable on future gas revenues.

**7 Inventory**

Inventory of crude oil at September 30, 2006 and December 31, 2005 consisted of the following:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Crude oil	\$ 416,822	\$ 886,250
	\$ 416,822	\$ 886,250

**8 Prepayments**

Prepayments consisted of the following at September 30, 2006 and December 31, 2005:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Drilling Contractors and Pipeline Suppliers	\$ 4,730,437	\$ 4,053,471
Financing Fees	96,408	115,158
Other	402,687	207,226
	\$ 5,229,532	\$ 4,375,855

**9 Investments**

Investments at September 30, 2006 consisted of bank deposits with a maturity date of April 27, 2008. These deposits have been placed to satisfy local Kazakhstan requirements in respect of asset retirement obligations.

**10 Prepaid financing fees**

Prepaid financing fees at September 30, 2006 and December 31, 2005:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Commission and Professional fees	\$ 471,664	\$ 246,910
	\$ 471,664	\$ 246,910

Prepaid financing fees as at September 30, 2006 are corporate finance fees incurred in respect of the private placement of a \$25,000,000 issue of Senior Convertible Secured Notes due July 25, 2009, a \$13,000,000 issue of Senior Subordinated Convertible Guaranteed Notes





**Table of Contents**

due September 1, 2009, a \$10,000,000 issue of a 12% Subordinated Convertible Guaranteed Note due June 28, 2010 and a \$5,000,000 issue of Senior Secured Notes by CanArgo's wholly owned subsidiary Tethys, with a group of investors, discussed in Note 12 and which are to be amortized as interest payable over the term of the loans.

Prepaid financing fees as at December 31, 2005 are corporate finance fees incurred in respect of the private placement of a \$25,000,000 issue of Senior Convertible Secured Notes due July 25, 2009.

**11 Capital Assets**

Capital assets, net of accumulated depreciation and impairment, include the following at September 30, 2006:

	Cost	(Unaudited) Accumulated Depreciation And Impairment	Net Capital Assets
Oil and Gas Properties			
Proved properties	\$ 97,639,354	\$ (27,912,571)	\$ 69,726,783
Unproved properties	59,600,917		59,600,917
	157,240,271	(27,912,571)	129,327,700
Property and Equipment			
Oil and gas related equipment	13,916,939	(5,485,544)	8,431,395
Office furniture, fixtures and equipment and other	1,322,763	(491,263)	831,500
	15,239,702	(5,976,807)	9,262,895
	\$ 172,479,973	\$ (33,889,378)	\$ 138,590,595

Capital assets, net of accumulated depreciation and impairment, include the following at December 31, 2005:

	Cost	(Audited) Accumulated Depreciation And Impairment	Net Capital Assets
Oil and Gas Properties			
Proved properties	\$ 83,451,848	\$ (26,033,501)	\$ 57,418,347
Unproved properties	50,644,999		50,644,999
	134,096,847	(26,033,501)	108,063,346
Property and Equipment			
Oil and gas related equipment	15,453,405	(5,146,040)	10,307,365
Office furniture, fixtures and equipment and other	1,135,601	(458,263)	677,338

16,589,006 (5,604,303) 10,984,703

\$ 150,685,853 \$ (31,637,804) \$ 119,048,049

Oil and Gas Properties

Unproved property additions relate to our exploration activity in the period.

10

---

**Table of Contents**

During the period we transferred \$6,369,369 of capital asset costs, into the full cost pool from unproved properties, relating to an abandonment of part of the Norio MK72 well and a 25% field acreage relinquishment of the Norio Production Sharing Agreement.

**Property and Equipment**

Oil and gas related equipment includes materials, drilling rigs and related equipment currently in use by us in the development of the Ninotsminda and Norio Fields.

**12 Loans Payable and Long Term Debt**

Loans payable at September 30, 2006 and December 31, 2005 consisted of the following:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Short term loans payable:		
Loan with detachable warrants	\$	\$ 1,050,000
Unamortized debt discount		(85,858)
Loans payable	\$	\$ 964,142
Long term debt:		
Senior Convertible Secured Loan Notes	\$ 25,000,000	\$ 25,000,000
Senior Subordinated Convertible Guaranteed Loan Notes	13,000,000	
12% Subordinated Convertible Guaranteed Loan Note	10,000,000	
Tethys Senior Secured Notes	5,000,000	
Unamortized debt discount	(13,881,979)	
Long term debt	\$ 39,118,021	\$ 25,000,000

In order to ensure timely procurement of long lead items for our drilling programs in Georgia and Kazakhstan and for working capital purposes, we have entered into a number of loan agreements of which those outstanding during the third quarter of 2006 are described below.

*Long Term Loan with Detachable Warrants:* This loan, the balance of which was \$1,050,000 at date of conversion, from Salahi Ozturk was advanced pursuant to the amended and restated loan and warrant agreement dated August 27, 2004. On February 14, 2006 the loan converted into 1,521,739 shares of our common stock.

*Senior Secured Convertible Notes:* On July 25, 2005, CanArgo completed a private placement of \$25,000,000 in aggregate principal amount of our Senior Convertible Secured Loan Notes due July 25, 2009 (the Senior Secured Notes) with a group of private investors (the Purchasers) all of which qualified as accredited investors under Rule 501(a) promulgated under the Securities Act of 1933 as amended, (the Securities Act) arranged through Ingalls & Snyder LLC of New York City, as Placement Agent, pursuant to a Note Purchase Agreement of even date (the Senior Note Purchase Agreement). The Company paid approximately \$100,000 of legal fees for the Purchasers and a \$250,000 arrangement fee to Orion Securities in connection with the Senior Secured Notes.

The unpaid principal balance under the Senior Secured Notes bears interest (computed on the basis of a 360-day year of twelve 30-day months) (a) at increasing rates ranging from 3% from the date of issuance to December 31, 2005; 10% from January 1, 2006 until December 31, 2006; and 15% from January 1, 2007 until final payment, payable semi-annually, on June 30 and December 30, commencing December 30, 2005, until the principal shall have become due and payable, and (b) at 3% above the applicable rate on any overdue payments of principal and interest,



**Table of Contents**

Pursuant to the provisions of Emerging Issue Task Force 86-15: Increasing-Rate Debt, the Company recognizes interest expense using the effective interest rate method, which results in the use of a constant interest rate for the life of the Senior Secured Notes. The effective interest rate is approximately 12.3% per annum. The difference between the interest computed using the actual interest rate in effect (3% per annum to December 31, 2005 and 10% from January 1, 2006) and the effective interest rate (12.3% per annum) totalled \$1,432,290 as of September 30, 2006 and has been accrued as a non-current liability.

The Company is amortising the professional fees incurred in relation to the Senior Secured Notes over the term of the Senior Secured Notes.

The Senior Secured Notes are convertible any time, in whole or in part, at the option of the Note holder, into shares of CanArgo common stock (the Conversion Stock) which is subject to (a) customary anti-dilution adjustments and (b) adjustment if CanArgo issues any equity securities (other than pursuant to the granting of employee stock options pursuant to shareholder approved employee stock option plans or existing outstanding options, warrants and convertible securities), at a price per share of less than \$0.90 per share, as adjusted (the CanArgo Conversion Price), determined net of all discounts, fees, costs and expenses incurred in connection with such issuance, in which case the CanArgo Conversion Price will be reset to such lower price.

We may, at our option without the consent of Note holders, upon not less than 90 days and not more than 120 days prior written notice, prepay at any time and from time to time after July 31, 2006, all or any part of the Senior Secured Notes, in a principal amount of not less than \$100,000 at the following Redemption Prices (expressed as percentages of the principal amount so prepaid): 105% after July 31, 2006; 104% after January 1, 2007; 103% after July 1, 2007; 102% after January 1, 2008; 101% after July 1, 2008, and 100% after January 1, 2009, together with all accrued and unpaid interest.

The Senior Secured Notes are subject to mandatory prepayment due to a change in control of the Company, as defined by the Senior Note Purchase Agreement.

In connection with the execution and delivery of the Senior Note Purchase Agreement, CanArgo entered into a Registration Rights Agreement with the Purchasers pursuant to which it agreed to register the Conversion Stock for resale under the Securities Act and indemnify the purchasers in connection with the registration. Under the terms of a Registration Rights Agreement the Company provided the Purchasers with certain registration rights with respect to the Conversion Stock. The Conversion Stock was registered on a Registration Statement on Form S-1 which was declared effective by the SEC on January 30, 2006.

The Senior Secured Notes are secured by substantially all of the assets of the Company and its subsidiaries and contain certain negative and affirmative covenants and also restricts the ability of the Company to pay dividends to its common stockholders until the loan and all accrued interest have been paid or the Note holders elect to convert their loans to common stock. (See page 35 Liquidity and Capital Resources section of Item 2 below for a more detailed discussion of covenants).

The Company evaluated the embedded conversion feature in this debt and determined it did not meet the criteria for bifurcation under SFAS No 133 Accounting for Derivative Instruments and Hedging Activities during the quarter.

*Senior Subordinated Convertible Guaranteed Notes:* On March 3, 2006, we finalised a private placement with a limited group of investors arranged by Ingalls & Snyder LLC of New York City of a \$13,000,000 issue of Senior Subordinated Convertible Guaranteed Notes due September 1, 2009 (the Senior Subordinated Notes) and warrants to purchase an aggregate of 13,000,000 shares of our common stock, par value \$0.10 per share (Warrant Shares) at an exercise price of \$1.37 per share, subject to adjustment as defined below, and expiring on March 3, 2008 or sooner under certain circumstances (Warrants).

The proceeds of this financing, after the payment of all placing expenses and professional fees estimated at \$150,000, are being used to fund the development of the Kyzylol Gas Field in Kazakhstan and on the commitment exploration programs in Kazakhstan through Tethys

**Table of Contents**

Petroleum Limited ( Tethys ), the wholly owned subsidiary of CanArgo which holds CanArgo's Kazakhstan assets.

Pursuant to the provisions of Emerging Issue Task Force 86-15: Increasing-Rate Debt, the Company recognizes interest expense using the effective interest rate method, which results in the use of a constant interest rate for the life of the Senior Subordinated Notes. The effective interest rate is approximately 8.3% per annum. The difference between the interest computed using the actual interest rate in effect (3% per annum to December 31, 2006 and 10% from January 1, 2007) and the effective interest rate (8.3% per annum) which totalled \$4,401,230 as of September 30, 2006 and has been accrued as a non-current liability.

We entered into a Note and Warrant Purchase Agreement dated as of March 3, 2006 ( Senior Subordinated Note Purchase Agreement ) with a limited group of private investors (the Purchasers ) all of whom qualified as accredited investors under Rule 501(a) promulgated under the Securities Act. Pursuant to the Note Purchase Agreement, we issued the Senior Subordinated Notes, one of which was issued to Ingalls & Snyder LLC as nominee for certain Purchasers, and the Warrants, one of which was also issued to Ingalls & Snyder LLC as nominee for certain Purchasers, in a transaction intended to qualify for an exemption from registration under the Securities Act pursuant to Section 4(2) thereof and Regulation D promulgated thereunder. For purposes hereof each of the Purchasers for whom Ingalls & Snyder LLC acts as nominee is deemed a beneficial holder of the Senior Subordinated Note and Warrant issued in Ingalls & Snyder LLC's name and such Purchasers may each be assigned their own Senior Subordinated Note and Warrant as provided in the Senior Subordinated Note Purchase Agreement.

The principal terms of the Senior Subordinated Note Purchase Agreement and related agreements include the following:

*Interest.* The unpaid principal balance under the Senior Subordinated Notes bears interest (computed on the basis of a 360-day year of twelve 30-day months) payable semi-annually on June 30 and December 30 in cash at the rate of 3% per annum until December 31, 2006 and 10% per annum thereafter and (b) at the rate of 3% per annum above the applicable rate on any overdue payments of principal and interest.

*Optional Prepayments.* CanArgo may, at its option, upon at least not less than 60 days and not more than 120 days prior written notice, prepay at any time and from time to time after March 1, 2007, all or any part of the Senior Subordinated Notes, in a principal amount of not less than \$100,000 at the following Redemption Prices (expressed as percentages of the principal amount so prepaid): 105% after March 1, 2007; 104% after September 1, 2007; 103% after March 1, 2008; 102% after September 1, 2008; 101% after March 1, 2009, and 100% after September 1, 2009, together with all accrued and unpaid interest.

*Mandatory Prepayment.* CanArgo will not take any action to consummate a Change of Control (or Change of Control contemplated by a Control Event) unless it shall offer to prepay all, but not less than all, of the Senior Subordinated Notes, on not less than 15 business days prior written notice, in the event of an occurrence of a Change of Control or Control Event. Mandatory prepayment of the Senior Subordinated Notes shall be in an amount equal to 101% of the outstanding principal amount of such Senior Subordinated Notes, together with interest on such Senior Subordinated Notes accrued to the date of prepayment. *Change in Control* is defined to mean (a) if CanArgo shall at any time cease to be a publicly held company or cease to have its capital stock traded on an exchange or (b) a transaction or series of related transactions pursuant to which (i) at least fifty-one percent (51%) of the outstanding shares of CanArgo's common stock or, on a fully diluted basis, shall subsequent to March 3, 2006 be owned by any person which is not related to or affiliated with CanArgo, (ii) if CanArgo merges into or with, consolidates with or effects any plan of share exchange or other combination with any person which is not related to or affiliated with CanArgo, or (iii) if CanArgo disposes of all or substantially all of its assets other than in the ordinary course of business and *Control Event* is defined to mean (i) the execution by CanArgo or any material subsidiary of CanArgo which has guaranteed the indebtedness evidenced by the Senior Subordinated Notes (a CanArgo Group Member ) of any agreement or letter of intent with respect to any proposed transaction or event or series of transactions or events which, individually or in the aggregate, may reasonably be expected to result in a Change in Control, or (ii) the execution of any written agreement which, when fully performed by the parties thereto, would result in a Change in Control.

**Table of Contents**

*Conversion.* The Senior Subordinated Notes are convertible, in whole or in part, (A) into shares of CanArgo common stock ( CanArgo Conversion Stock ) at a conversion price per share of \$1.37 (the CanArgo Conversion Price ), which is subject to adjustment if CanArgo issues any equity securities (other than pursuant to the granting of employee stock options pursuant to shareholder approved employee stock option plans or existing outstanding options, warrants and convertible securities, including, without limitation, the Company s Senior Secured Notes) at a price per share of less than \$1.37 per share, as adjusted, determined net of all discounts, fees, costs and expenses incurred in connection with such issuance, in which case the CanArgo Conversion Price will be reset to such lower price and (B) for a period of one year from closing (or until 30 days after receipt of the consent of the Senior Secured Note holders is obtained if such conversion is prevented under the terms of the Senior Secured Notes) into shares of common stock of Tethys, with a nominal value of £0.10 per share ( Tethys Conversion Stock ) and together with the CanArgo Conversion Stock, collectively, the Conversion Stock ) at a conversion price per share based on a formula determined by dividing the sum of \$52 million plus the amount of any unreimbursed amounts advanced by the Company to Tethys by 100,000 ( Tethys Conversion Price ) and together with the CanArgo Conversion Price, collectively, the Conversion Price ) in the Note holders Relevant Percentages (as defined in the Senior Subordinated Note Purchase Agreement). The Conversion Price shall also be adjusted in connection with any stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or any similar transaction, in which case the Conversion Price and number of shares of Conversion Stock will be appropriately adjusted to reflect any such event, such that the holders of the Senior Subordinated Notes will receive upon conversion the identical number of shares of common stock or other consideration or property to be received by the holders of the common stock as if the holders had converted the Senior Subordinated Notes immediately prior to any such event as such amount would then be adjusted by reason of such stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or other similar transaction; provided, however, in no event shall the number of shares of common stock issuable to the Purchasers upon conversion cause the Purchasers to collectively own in excess of 19.9% of the shares of CanArgo common stock outstanding as of March 3, 2006 absent shareholder approval in accordance with applicable stock exchange requirements. No fractional shares of common stock shall be issued upon any conversion; instead the Conversion Price shall be appropriately adjusted so that holders shall receive the nearest whole number of shares upon any conversion.

In connection with the execution and delivery of the Senior Subordinated Note Purchase Agreement, CanArgo entered into a Registration Rights Agreement with the Purchasers pursuant to which it agreed to register the CanArgo Conversion Stock and the Warrant Shares for resale under the Securities Act. Pursuant to the terms of the Registration Rights Agreement the Company provided the Purchasers with certain registration rights with respect to all shares of the Company s common stock issuable upon conversion of the Senior Subordinated Notes and all shares of the Company s common stock issuable upon exercise of the Warrants. The Company has not provided the Purchasers with any registration rights in relation to the Tethys Conversion Stock. Under the Registration Rights Agreement the Company has agreed to use all commercially reasonable efforts to file a Registration Statement on Form S-3 or Form S-1 in respect of the CanArgo Conversion Stock by December 31, 2006.

*Security.* Payment of all amounts due and payable under the Senior Subordinated Note Purchase Agreement, the Senior Subordinated Note and all related agreements (collectively, the Loan Documents ) is secured by subordinated guarantees from each other CanArgo Group Member (the Subordinated Subsidiary Guaranty ). If CanArgo forms or acquires a Material Subsidiary (as defined in the Senior Subordinated Note Purchase Agreement) it shall cause such Subsidiary to execute a Subordinated Subsidiary Guaranty (other than for certain excepted companies and legal entities) and thereby become a CanArgo Group Member subject to the provisions of the Senior Subordinated Note Purchase Agreement.

*Subordination.* Payments on the Senior Subordinated Notes and under the Subordinated Subsidiary Guaranty are subordinated and junior in right of payment to the prior payment or conversion in full of CanArgo s Senior Indebtedness in the event of the bankruptcy, insolvency or other reorganization of CanArgo. Under the terms of the subordination, holders of the Senior Subordinated Notes agree for the benefit of the holders of the Senior Indebtedness to certain limitations on their right to accelerate or demand payment under the Senior Subordinated Notes or otherwise realize under the Subordinated Subsidiary Guaranty





**Table of Contents**

in the event of a default under the Senior Indebtedness. *Senior Indebtedness* is defined to mean (i) all indebtedness under the Senior Secured Notes or any related agreements; (ii) certain permitted indebtedness now existing or hereafter arising, and (iii) all renewals, refinancings, extensions, modifications and replacements of any of the foregoing.

*Covenants.* Under the terms of the Senior Subordinated Note Purchase Agreement CanArgo is subject to certain affirmative and negative covenants, which can be waived by the beneficial holders of at least 50% of the outstanding principal amount of the Senior Subordinated Notes (the *Required Holders* ), including the following affirmative and negative covenants, respectively: (a) providing current information regarding CanArgo and rights of inspection; compliance with laws; maintenance of corporate existence, insurance and properties; payment of taxes; adding new material subsidiaries as additional guarantors under the Subordinated Subsidiary Guaranty; payment of professional fees for the Purchasers (not in excess of US\$75,000), and (b) restrictions on: transactions with affiliates; mergers, consolidations and sales of all of CanArgo's assets; liens (except for certain permitted liens); the issuance of additional senior indebtedness; changes in CanArgo's line of business; certain types of payments; sale-and leasebacks; sales of assets other than in the ordinary course of business; future Indebtedness, as defined in the Senior Subordinated Note Purchase Agreement (other than certain permitted indebtedness); cancelling, terminating, waiving or amending provisions of, or selling any interests in (other than under certain circumstances) any of the Basic Agreements (as defined in the Senior Subordinated Note Purchase Agreement); adopting any anti-take-over defences except as permitted by the Senior Subordinated Note Purchase Agreement, and restricting distributions of Tethys cash flow to CanArgo except for certain reimbursements of payments made by CanArgo on Tethys' behalf, or in respect of management fees and overhead not to exceed \$100,000 per month. CanArgo is not subject to any financial covenants, such as the maintenance of minimum net worth or coverage ratios, other than the restriction on its ability to incur additional Indebtedness.

*Events of Default.* An Event of Default shall exist if one or more of the following occurs and is continuing: (i) failure to pay when due any principal and, after 5 business days, any interest, payable under the Senior Subordinated Note or any Loan Document; (ii) default in the performance of certain enumerated covenants; (iii) default in the performance or compliance with any other terms which remains unremedied for 30 days after the earlier of a Responsible Officer first obtaining actual and not constructive knowledge of the default or the receipt of notice; (iv) any representation or warranty made in writing on behalf of CanArgo or any other CanArgo Group Member proves to have been false or incorrect in any material respect; (v) customary events involving bankruptcy, insolvency or reorganization; (vi) the entry of a final judgment or judgments in excess of \$2,500,000 (uncovered by insurance), which is not discharged or settled; (vii) violations of ERISA or the Internal Revenue Code of 1986, as amended, under funding of accrued benefit liabilities and other matters relating to employee benefit plans subject to ERISA or Foreign Pension Plans; (viii) any Loan Document ceases to be in full force and effect (except in accordance with its terms) or its validity is challenged by CanArgo or any affiliate; (ix) CanArgo or any other CanArgo Group Member modifies its Charter Document which results in a Default or Event of Default or will adversely affect the rights of Note holders (other than for an increase in the number of authorized shares of the Company's common stock from 300 million to 375 million shares); or (x) a change occurs in the consolidated financial condition of CanArgo or in the physical, operational or financial status of the Properties (as defined in the Senior Subordinated Note Purchase Agreement), which change has a Material Adverse Effect (as defined in the Senior Subordinated Note Purchase Agreement).

Other than for certain Events of Default that will result in an automatic acceleration without notice, such as bankruptcy, if an Event of Default occurs and is continuing, the Required Holders may at any time at its or their option, by notice to CanArgo, declare all outstanding Senior Subordinated Notes to be immediately due and payable and holders of the Senior Subordinated Note may proceed to enforce their rights under the Loan Documents at law or in equity. CanArgo is responsible for the payment of all costs of collection, including all reasonable legal fees actually incurred in connection therewith.

*Warrants.* The Warrants expire on March 3, 2008 or such sooner date at the election of the Company and upon at least 30 days prior written notice in the event that the Manavi M12 well indicates, by an independent engineering report, sustainable production, if developed, in excess of 7,500 barrels of oil per day, and are exercisable at an exercise price of \$1.37 per share ( *Exercise Price* ), subject to adjustment in connection with any stock split, stock dividend, reverse

stock split, reclassification, recapitalization, combination, merger,

**Table of Contents**

consolidation or any similar transaction, in which case the Exercise Price and number of Warrant Shares will be appropriately adjusted to reflect any such event, such that the holders of the Warrants will receive upon exercise the identical number of shares of common stock or other consideration or property to be received by the holders of the common stock as if the holders had exercised the Warrants immediately prior to any such event as such amount would then be adjusted by reason of such stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or other similar transaction. If CanArgo issues any equity securities (other than pursuant to the granting of employee stock options pursuant to shareholder approved employee stock option plans or existing outstanding options, warrants and convertible securities, including, without limitation, the conversion of the Senior Secured Notes) at a price per share of less than \$1.37 per share, as adjusted, determined net of all discounts, fees, costs and expenses incurred in connection with such issuance, the Exercise Price will be reset to such lower price; provided, however, in no event shall the number of Warrant Shares issuable upon exercise cause Warrant holders to collectively own in excess of 19.9% of the shares of CanArgo common stock outstanding as of March 3, 2006 absent shareholder approval in accordance with applicable stock exchange requirements. No fractional shares of common stock shall be issued upon any exercise; instead the Exercise Price shall be appropriately adjusted so that holders shall receive the nearest whole number of shares upon any conversion.

*Miscellaneous.* The execution of the Senior Subordinated Note Purchase Agreement was conditional upon the consent, which was obtained, from 51% of the holders of the Senior Secured Notes pursuant to a Waiver, Consent and Amendment dated as of March 3, 2006 ( Waiver, Consent and Amendment Agreement ). Under the terms of the Waiver, Consent and Amendment Agreement, the holders of the Senior Secured Notes further consented to certain amendments to the Note Purchase Agreement dated July 25, 2005 among the Company and Ingalls & Snyder Value Partners, L.P together with the other purchasers listed therein to provide for the amendment or termination of the Company s or any of the Subsidiaries interests in the Production Sharing Contract dated May 2001 among the State Agency of Georgia, Georgian Oil and National Petroleum Limited (the Samgori PSC ), a Basic Document as defined in the Senior Note Purchase Agreement, including without limitation, a waiver of the negative covenants set forth in Section 11.10 of the Senior Note Purchase Agreement and an increase in the authorized capital stock of the Company to 380 million shares of which 375 million shares shall constitute common stock and 5 million shares shall constitute preferred stock. The Senior Subordinated Note Purchase Agreement, the Senior Subordinated Note, the Subordinated Subsidiary Guaranty and the Registration Rights Agreement are all governed by New York Law and the Warrants are governed by the laws of the State of Delaware; the CanArgo Group Members party thereto subject themselves to the jurisdiction of New York Courts and waive the right to jury trial.

The Company evaluated the embedded conversion feature in this debt and determined it did not meet the criteria for bifurcation under SFAS No 133 Accounting for Derivative Instruments and Hedging Activities during the quarter.

Pursuant to EITF 98-5 Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and EITF 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments , the Company had initially recorded a discount to the Senior Subordinated Note in the amount of approximately \$6,483,000 based on the relative fair value of the beneficial conversion feature and warrants of \$2,245,000 and \$4,238,000, respectively.

We used the following assumptions to determine the fair value of the Senior Subordinated Notes and Warrants:

	Additional Loan
Stock price on date of grant	\$ 1.16
Risk free rate of interest	4.72%
Expected life of warrant months	24
Dividend rate	
Historical volatility	68.6%

On June 28, 2006, we announced that we had entered into the private placement with Persistency, a Cayman Islands company, of a \$10,000,000 issue of a 12% Subordinated



**Table of Contents**

Convertible Guaranteed Note due June 28, 2010 (see 12% Subordinated Convertible Guaranteed Note below) and warrants to purchase an aggregate of 12,500,000 shares of CanArgo common stock ( Warrant Shares ), at an exercise price of \$1.00 per share, subject to adjustment, and expiring on June 28, 2008 or sooner under certain circumstances (the 12% Note Warrants ) which is described more fully below.

As a result of entering into this private placement we issued warrants at an exercise price below \$1.37 and therefore the terms of the Senior Subordinated Note Purchase Agreement and related agreements dictated that the conversion and warrant exercise prices under the Senior Subordinated Note Purchase Agreement be reset to \$1.00 per share as described above.

The Company therefore recorded an additional debt discount of \$3,683,000 to the Senior Subordinated Note, increasing the total debt discount to approximately \$10,166,000 based on the relative fair value of the beneficial conversion feature and warrants of \$6,123,000 and \$4,043,000, respectively.

The Company has announced that it is planning listing the securities of Tethys on the Alternative Investment Market of the London Stock Exchange in connection with a proposed offering of Tethys shares, by Tethys and the Company (the Tethys Spin-Out ), with the primary aim of raising additional capital to finance further development and exploration programs in Kazakhstan. It is currently planned that the Company will retain a significant, but not controlling, equity interest in Tethys. The Tethys Spin-Out is currently planned for later this year, dependant on market conditions, pricing etc.

In a separate transaction Persistency have arranged the acquisition of \$5 million of the Senior Subordinated Notes including its conversion obligations into Tethys.

On June 28, 2006, the Company entered into a conversion agreement ( Conversion Agreement ) with the holders of the Senior Subordinated Notes. The Senior Subordinated Notes are to be converted within 5 days prior to the effective date of any Tethys Spin-Out. Provided that the Tethys Spin-Out is completed on a pre-money enterprise value of at least \$52,000,000, the conversion price of the Senior Subordinated Notes will be in accordance with the terms of the Senior Subordinated Notes. In the event that the Tethys Spin-Out is completed on a pre-money enterprise value of less than \$52,000,000, the Subordinated Noteholders shall be issued additional shares of Tethys common stock to cause the aggregate value of the Tethys common stock issued upon conversion to equal \$13,000,000 at the Spin-Out price.

As an inducement for the Note holders to convert the Senior Subordinated Notes into Tethys common stock, the Company agreed to issue the Note holders 13,000,000 warrants ( Compensation Warrants ) to purchase CanArgo common stock at an exercise price of \$1.00 per common share. We issued Compensation Warrants to purchase 5,000,000 shares on June 28, 2006 to Persistency, subject to restrictions on their right to sell, borrow against or pledge the underlying common stock until the Tethys Spin Out is effective. In addition, we entered into an irrevocable call option in which the Company has the right, but not the obligation, to repurchase the underlying common stock at \$1 per share in the event that Persistency exercises its rights under the warrant and acquires our common stock and the Tethys Spin Out is never consummated. The remaining Compensation Warrants are effective upon the conversion of the Senior Subordinated Notes into Tethys common stock. All of the Compensation Warrants expire on the earlier of: (i) September 1, 2009; (ii) or such sooner date at the election of the Company and upon at least thirty (30) days prior written notice to the Registered Holder in the event that: (a) the Manavi M12 well indicates, by way of an independent engineering report, sustainable production, if developed, in excess of 7,500 barrels of oil per day or (b) all the warrants originally issued under certain Note and Warrant Purchase Agreement dated as of March 3, 2006 by and among the Company and the purchasers listed therein are exercised by the holders thereof and the average closing price for the Company's Common Stock on the American Stock Exchange or, if the Common Stock is not then listed for trading on the American Stock Exchange ( AMEX ) then the Oslo Stock Exchange, is above U.S. \$2.00 (or its equivalent in NOK, and in any case adjusted for any stock dividends, stock split, its reverse split, recapitalization or reorganization) for a period of five consecutive trading days; or (iii) in the event the Tethys Spin-Out does not occur on or prior to December 31, 2006 (the Exercise Period ). The Exercise Period may also be extended by the Company's Board of Directors.

**Table of Contents**

Pursuant to FAS 84 Induced Conversions of Convertible Debt an Amendment of APB Opinion No. 26, the Company will recognize the fair market value of the Compensation Warrants as of the date of the Conversion Agreement as an expense at the time of the conversion of the Senior Subordinated Notes. Had the Conversion Agreement been effective as of September 30, 2006, the Company would have recorded compensation from the Compensation Warrants of \$3,827,200 based on a valuation using the Black-Scholes model. If the Senior Subordinated Notes are not converted to Tethys common stock per the terms of the Conversion Agreement, the Compensation Warrants will expire and the Company will not recognize any expense related to this inducement to convert. As of September 30, 2006, the fair market value of the Compensation Warrants is a contingent liability and was not recorded in the September 30, 2006 balance sheet or statement of operations.

We used the following assumptions in our Black Scholes model to determine the fair value of the Senior Subordinated Notes and Warrants:

	Additional Loan
Stock price on date of grant	\$ 0.74
Risk free rate of interest	5.3%
Expected life of warrant days	1,161
Dividend rate	
Historical volatility	64.3%

*12% Subordinated Convertible Guaranteed Note*: On June 28, 2006, we entered into a \$10,000,000 private placement with Persistency (the Purchaser) of a 12% Subordinated Convertible Guaranteed Note due June 28, 2010 (the 12% Note) and warrants to purchase an aggregate of 12,500,000 shares of CanArgo common stock (Warrant Shares), at an exercise price of \$1.00 per share, subject to adjustment, and expiring on June 28, 2008 or sooner under certain circumstances (the 12% Note Warrants).

The proceeds of this financing, after the payment of all placing expenses and professional fees (estimated at \$150,000), will be used to fund our appraisal and development activities in Georgia including further development of the Ninotsminda Field and potentially appraisal of the Kumisi gas discovery.

We entered into a Note and Warrant Purchase Agreement dated as of June 28, 2006 (12% Note Purchase Agreement) with the Purchaser which qualified as an accredited investor under Rule 501(a) promulgated under the Securities Act. Pursuant to the 12% Note Purchase Agreement, we issued the 12% Note and the 12% Note Warrants in a transaction intended to qualify for an exemption from registration under the Securities Act pursuant to Section 4(2) thereof and Regulation D promulgated thereunder.

The terms of the 12% Note Purchase Agreement and related agreements include the following:

*Interest.* The unpaid principal balance under the 12% Note bears interest (computed on the basis of a 360-day year of twelve 30-day months) payable semi-annually on June 30 and December 31, commencing December 31, 2006, in cash at the rate of 12% per annum and (b) at the rate of 15% per annum on any overdue payments of principal and interest.

*Optional Prepayments.* CanArgo may, at its option, upon at least not less than 60 days and not more than 120 days prior written notice, prepay at any time and from time to time after June 28, 2007, any part of the 12% Notes up to an aggregate of \$5,000,000 in aggregate principal amount, in multiples of not less than \$100,000, and at any time after June 28, 2008 the remaining outstanding principal amount at the following Redemption Prices (expressed as percentages of the principal amount so prepaid): 105% after June 28, 2007 and 103% after June 28, 2008, together with all accrued and unpaid interest.

*Mandatory Prepayment.* CanArgo will not take any action to consummate a Change of Control (or Change of Control contemplated by a Control Event) unless it shall offer to prepay all, but not less than all, of the 12% Note, on not less than 15 business days prior written notice, in the event of an occurrence of a Change of Control or Control Event. Mandatory prepayment of the 12% Note shall be in an amount equal to 101% of the outstanding principal amount of such 12% Note, together with interest on such 12% Note accrued to the date of prepayment. *Change in Control* is defined to mean (a) if CanArgo shall at any time cease to be a publicly held company or cease to have its capital stock traded



**Table of Contents**

on an exchange or (b) a transaction or series of related transactions pursuant to which (i) at least fifty-one percent (51%) of the outstanding shares of CanArgo's common stock or, on a fully diluted basis, shall subsequent to June 28, 2006 be owned by any person which is not related to or affiliated with CanArgo, (ii) if CanArgo merges into or with, consolidates with or effects any plan of share exchange or other combination with any person which is not related to or affiliated with CanArgo, or (iii) if CanArgo disposes of all or substantially all of its assets other than in the ordinary course of business; provided, the disposition of Tethys in an offering subject to certain conditions will not be deemed the disposition of all or substantially all of CanArgo's assets and *Control Event* is defined to mean (i) the execution by CanArgo or any material subsidiary of CanArgo which has guaranteed the indebtedness evidenced by the 12% Note (a *CanArgo Group Member*) of any agreement or letter of intent with respect to any proposed transaction or event or series of transactions or events which, individually or in the aggregate, may reasonably be expected to result in a Change in Control, or (ii) the execution of any written agreement which, when fully performed by the parties thereto, would result in a Change in Control.

*Conversion.* The 12% Note is convertible, in whole or in part, into shares of CanArgo common stock (*CanArgo Conversion Stock*) at a conversion price per share of \$1.00 (the *CanArgo Conversion Price*), which is subject to adjustment: (a) if CanArgo issues any equity securities (other than pursuant to the granting of employee stock options pursuant to shareholder approved employee stock option plans or existing outstanding options, warrants and convertible securities, including without limitation the Company's Senior Secured Notes and Senior Subordinated Notes) at a price per share of less than \$1.00 per share, as adjusted, determined net of all discounts, fees, costs and expenses incurred in connection with such issuance, in which case the *CanArgo Conversion Price* will be reset to such lower price. The *CanArgo Conversion Price* shall also be adjusted in connection with any stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or any similar transaction, in which case the *CanArgo Conversion Price* and number of shares of *CanArgo Conversion Stock* will be appropriately adjusted to reflect any such event, such that the holder of the 12% Note will receive upon conversion the identical number of shares of CanArgo common stock or other consideration or property to be received by the holder of the CanArgo common stock as if the holder had converted the 12% Note immediately prior to any such event as such amount would then be adjusted by reason of such stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or other similar transaction; provided, however, in no event shall the number of shares of CanArgo Common Stock issuable to the Purchasers upon conversion cause the Purchasers to collectively own in excess of 19.9% of the shares of CanArgo common stock outstanding as of June 28, 2006 absent shareholder approval in accordance with applicable stock exchange requirements. The 12% Note is subject to mandatory conversion under certain circumstances. No fractional shares of CanArgo common stock shall be issued upon any conversion; instead the *CanArgo Conversion Price* shall be appropriately adjusted so that holders shall receive the nearest whole number of shares upon any conversion.

In connection with the execution and delivery of the 12% Note Purchase Agreement, CanArgo entered into a Registration Rights Agreement with the Purchasers pursuant to which it agreed to register the *CanArgo Conversion Stock* and the *Warrant Shares* for resale under the Securities Act. The Registration Rights Agreement gives the holders of the 12% Notes and 12% Note Warrants both demand and piggyback registration rights. In addition the Registration Rights Agreement requires us to use our best efforts to have a registration statement declared effective by December 31, 2006 and to maintain that effectiveness for a period of two years in the event that we use a Form S-3 and at least 90 days in the event we use a Form S-1 to register the shares. There is no penalty associated with our failure to perform under the Registration Rights Agreement.

*Security.* Payment of all amounts due and payable under the 12% Note Purchase Agreement, the 12% Note and all related agreements (collectively, the *Loan Documents*) is secured by subordinated guarantees from each other *CanArgo Group Member* (the *12% Subordinated Subsidiary Guaranty*). If CanArgo forms or acquires a *Material Subsidiary* (as defined in the 12% Note Purchase Agreement) it shall cause such Subsidiary to execute a *12% Subordinated Subsidiary Guaranty* (other than for certain excepted companies and legal entities) and thereby become a *CanArgo Group Member* subject to the provisions of the 12% Note Purchase Agreement.



**Table of Contents**

*Subordination.* Payments on the 12% Note and under the 12% Subordinated Subsidiary Guaranty is subordinated and junior in right of payment to the prior payment or conversion in full of CanArgo's Senior Indebtedness in the event of the bankruptcy, insolvency or other reorganization of CanArgo. Under the terms of the subordination, holders of the 12% Note agree for the benefit of the holders of the Senior Indebtedness to certain limitations on their right to accelerate or demand payment under the 12% Note or otherwise realize under the 12% Subordinated Subsidiary Guaranty in the event of a default under the Senior Indebtedness. *Senior Indebtedness* is defined to mean (i) all indebtedness under the Senior Secured Notes, the Senior Subordinated Notes, or any related agreements; (ii) certain permitted indebtedness now existing or hereafter arising, and (iii) all renewals, refinancings, extensions, modifications and replacements of the then outstanding principal amount owing under any of the foregoing.

*Covenants.* Under the terms of the 12% Note Purchase Agreement CanArgo is subject to certain affirmative and negative covenants, which can be waived by the beneficial holders of at least 50% of the outstanding principal amount of the 12% Notes (the *Required Holders*), including the following affirmative and negative covenants, respectively: (a) providing current information regarding CanArgo and rights of inspection; compliance with laws; maintenance of corporate existence, insurance and properties; payment of taxes; adding new material subsidiaries as additional guarantors under the 12% Subordinated Subsidiary Guaranty; payment of professional fees for the Purchaser (not in excess of \$75,000), and (b) restrictions on: transactions with affiliates; mergers, consolidations and sales of all of CanArgo's assets; liens (except for certain permitted liens); the issuance of additional senior indebtedness; changes in CanArgo's line of business; certain types of payments; sale-and leasebacks; sales of assets other than in the ordinary course of business; future Indebtedness, as defined in the 12% Note Purchase Agreement (other than certain permitted indebtedness); cancelling, terminating, waiving or amending provisions of, or selling any interests in (other than under certain circumstances) any of the Basic Agreements (as defined in the 12% Note Purchase Agreement); and adopting any anti-take-over defences except as permitted by the 12% Note Purchase Agreement. CanArgo is not subject to any financial covenants, such as the maintenance of minimum net worth or coverage ratios, other than the restriction on its ability to incur additional Indebtedness.

*Events of Default.* An *Event of Default* shall exist if one or more of the following occurs and is continuing: (i) failure to pay when due any principal and, after 5 business days, any interest, payable under the 12% Note or any Loan Document; (ii) default in the performance of certain enumerated covenants; (iii) default in the performance or compliance with any other terms which remains unremedied for 30 days after the earlier of a Responsible Officer first obtaining actual and not constructive knowledge of the default or the receipt of notice; (iv) any representation or warranty made in writing on behalf of CanArgo or any other CanArgo Group Member proves to have been false or incorrect in any material respect; (v) customary events involving bankruptcy, insolvency or reorganization; (vi) the entry of a final judgment or judgments in excess of \$2,500,000 (uncovered by insurance), which is not discharged or settled; (vii) violations of ERISA or the Internal Revenue Code of 1986, as amended, under funding of accrued benefit liabilities and other matters relating to employee benefit plans subject to ERISA or Foreign Pension Plans; (viii) any Loan Document ceases to be in full force and effect (except in accordance with its terms) or its validity is challenged by CanArgo or any affiliate; (ix) CanArgo or any other CanArgo Group Member modifies its Charter Document which results in a Default or Event of Default or will adversely affect the rights of 12% Note holders; or (x) a change occurs in the consolidated financial condition of CanArgo or in the physical, operational or financial status of the Properties (as defined in the Note Purchase Agreement), which change has a Material Adverse Effect (as defined in the Note Purchase Agreement).

Other than for certain Events of Default that will result in an automatic acceleration without notice, such as bankruptcy, if an Event of Default occurs and is continuing, the Required Holders may at any time at its or their option, by notice to CanArgo, declare all outstanding 12% Notes to be immediately due and payable and holders of the 12% Note may proceed to enforce their rights under the Loan Documents at law or in equity. CanArgo is responsible for the payment of all costs of collection, including all reasonable legal fees actually incurred in connection therewith.

*12% Note Warrants.* The 12% Note Warrants may be exercised at an exercise price of \$1.00 per share, subject to adjustment (the *Exercise Price*) in whole or in part at any time during the period (the *Exercise Period*) commencing on the first Business Day six (6) months after



**Table of Contents**

the date of issuance and terminating at the close of business on June 28, 2008 or shall be exercised on such sooner date at the election of the Company (a Mandatory Exercise ) and upon at least thirty (30) days prior written notice to the Registered Holder (the Mandatory Exercise Notice ) in the event that: (i) the Manavi M12 well indicates, by way of an independent engineering report, sustainable production, if developed, in excess of 7,500 barrels of oil per day or (ii) all the warrants originally issued under that certain Note and Warrant Purchase Agreement dated as of March 3, 2006 by and among the Company and the holders of the Senior Subordinated Notes are exercised by the holders thereof and the average closing price for the CanArgo Common Stock on the American Stock Exchange or, if the CanArgo Common Stock is not then listed for CanArgo's trading on the American Stock Exchange then the Oslo Stock Exchange, is above \$1.25 (or its equivalent in NOK, and in any case adjusted for any stock dividends, stock split, its reverse split, recapitalization or reorganization) for a period of five consecutive trading days (the Warrant Expiration Date ); except that (a) in the case of a Mandatory Conversion (as defined in the 12% Note Purchase Agreement), any and all outstanding 12% Note Warrants issued under the 12% Note Purchase Agreement and held by Purchaser shall automatically and simultaneously become immediately exercisable on receipt of the Mandatory Conversion Notice, and (b) in the case of a Mandatory Exercise, any and all outstanding 12% Notes issued under the 12% Note Purchase Agreement and held by Purchaser shall automatically and simultaneously become immediately convertible on receipt of the Mandatory Exercise Notice. The Exercise Period may also be extended by the Company's Board of Directors. The Exercise Price is subject to adjustment in connection with any stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or any similar transaction, in which case the Exercise Price and number of Warrant Shares will be appropriately adjusted to reflect any such event, such that the holders of the 12% Note Warrants will receive upon exercise the identical number of shares of CanArgo common stock or other consideration or property to be received by the holders of the CanArgo common stock as if the holders had exercised the 12% Note Warrants immediately prior to any such event as such amount would then be adjusted by reason of such stock split, stock dividend, reverse stock split, reclassification, recapitalization, combination, merger, consolidation or other similar transaction. If CanArgo issues any equity securities (other than pursuant to the granting of employee stock options pursuant to shareholder approved employee stock option plans or existing outstanding options, warrants and convertible securities, including without limitation the conversion of the Senior Secured Notes or the Senior Subordinated Notes) at a price per share of less than \$1.00 per share, as adjusted, determined net of all discounts, fees, costs and expenses incurred in connection with such issuance, the Exercise Price will be reset to such lower price; provided, however, in no event shall the number of Warrant Shares issuable upon exercise cause 12% Note Warrant holders to collectively own in excess of 19.9% of the shares of CanArgo common stock outstanding as of June 28, 2006 absent shareholder approval in accordance with applicable stock exchange requirements. The 12% Note Warrants may be converted at the election of the holders and with the concurrence of the Company into Warrant Shares on a net basis based upon the then spread between the Exercise Price and the market price of the Warrant Shares. No fractional shares of CanArgo common stock shall be issued upon any exercise; instead the Exercise Price shall be appropriately adjusted so that holders shall receive the nearest whole number of shares upon any conversion.

*Miscellaneous.* The execution of the 12% Note Purchase Agreement was conditional upon the consent, which was obtained, from 51% of the holders of the Senior Secured Notes and from 50% of the holders of the Senior Subordinated Notes each pursuant to Waiver and Consent Agreements each dated as of June 28, 2006. Under the terms of their Waiver and Consent Agreement, the holders of 51% in aggregate principal amount of the Senior Secured Notes further agreed to issue to the Purchaser an option to purchase their Senior Secured Notes at par in the event of Default and acceleration of the Senior Secured Notes provided that the Purchaser concurrently offers to purchase the remaining outstanding Senior Secured Notes on identical terms and conditions. The 12% Note Purchase Agreement, the 12% Note, the 12% Subordinated Subsidiary Guaranty and the Registration Rights Agreement are all governed by New York Law and the 12% Note Warrants are governed by the laws of the State of Delaware; the CanArgo Group Members party thereto subject themselves to the jurisdiction of New York Courts and waive the right to jury trial.

**Table of Contents**

The Company evaluated the embedded conversion feature in this debt and determined it did not meet the criteria for bifurcation under SFAS No 133 Accounting for Derivative Instruments and Hedging Activities during the quarter.

Pursuant to EITF 98-5 Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and EITF 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments, the Company has recorded a discount to the 12% Note in the amount of approximately \$2,700,000 based on the relative fair value of the beneficial conversion feature and warrants of \$50,000 and \$2,650,000, respectively.

We used the following assumptions to determine the fair value of the 12% Note and 12% Note Warrants:

	Additional
	Loan
Stock price on date of grant	\$ 0.74
Risk free rate of interest	5.30%
Expected life of warrant days	731
Dividend rate	
Historical volatility	64.3%

The discount is being amortized to interest expense over the life of the 12% Note using an effective interest rate of 10.1%. As of September 30, 2006 we had amortized \$242,839 of debt discount as interest expense. The total effective interest rate for the 12% Note is 22.1%.

*Senior secured notes in Tethys:* On September 7, we announced that Tethys had completed a \$5 million interim loan financing (the Tethys Bridge) to fund Tethys' development activities in Kazakhstan ahead of Tethys' planned spin-off and admission to the AIM market in London later this year. The funds are to be used by Tethys primarily for the purchase of pipeline, compressors and related equipment and services for the Kyzylloi field development. The financing took the form of the issue of \$5 million senior secured notes in Tethys redeemable on August 31, 2008 (the Tethys Notes) pursuant to a note and warrant or royalty purchase agreement dated September 5, 2006 (the Tethys NPA). Pursuant to the Tethys NPA, Tethys has the ability to pre-pay the Tethys Notes and the Tethys Notes fall to be automatically pre-paid in full following a change of control of Tethys which includes the admission of Tethys to AIM. Tethys has granted security over its bank account with HSBC Bank plc and its shareholding in its wholly owned subsidiary, Tethys Kazakhstan Limited, as a condition of the Tethys NPA with such security to be released on repayment of the funds. The Tethys Notes bear interest at the rate of 10% per annum for the period from the date of issue until December 31, 2006 and 15% per annum from January 1 2007 until they are repaid in full. The Tethys NPA contains certain affirmative and negative covenants on Tethys which apply provided at least \$500,000 in aggregate of the Tethys Notes is outstanding. The affirmative and negative covenants require Tethys among other things to maintain its corporate existence, to maintain insurance coverage on such terms and in such amounts as is customary in the case of entities in the same or similar businesses and which are similarly situated, to keep current with respect to payment of all due and payable taxes, to not permit Tethys to engage in transactions with affiliates unless they are in the ordinary course of business and on arm's length terms, to not enter into mergers or consolidations while a default or event of default is continuing or to allow liens on any pledged or secured assets under the NPA except specified permitted liens. In addition, while the covenants still apply Tethys must seek the permission of the noteholders to incur additional external third-part indebtedness in excess of \$2,500,000 except permitted indebtedness as specified in the Tethys NPA.

Pursuant to the provisions of Emerging Issue Task Force 86-15: Increasing-Rate Debt, the Company recognizes interest expense using the effective interest rate method, which results in the use of a constant interest rate for the life of the Tethys Notes. The effective interest rate is approximately 14.2% per annum. The difference between the interest computed using the actual interest rate in effect (10% per annum to December 31, 2006 and 15% from January 1, 2007) and the effective interest rate (14.2% per annum) totalled \$14,222 as of September 30, 2006 and has been accrued as a non-current liability.

Under the terms of the Tethys NPA, the holders of the Tethys Notes are entitled to receive additional consideration for the advance of the loan in the form of either (1) at closing of the



**Table of Contents**

fundraising, warrants to subscribe for ordinary shares in the capital of Tethys (the Tethys Warrants ) or (2) 90 days following first commercial sale of hydrocarbons, in which case Tethys may chose between granting the noteholder Tethys Warrants or entering into a royalty agreement with the noteholder. The Tethys Warrants shall be issued pursuant to the terms of an instrument by way of deed poll entered into by Tethys on September 5, 2006. The Tethys Warrants are exercisable in whole or in part at any time up to the expiry of 60 months from the date of the Tethys NPA. As of September 30, 2006, the number of ordinary shares in the capital of Tethys into which the Tethys Warrants are exercisable and the exercise price of the Tethys Warrants are based on an assumed valuation of Tethys, however, in the event of an AIM listing prior to July 31, 2007 the number of shares and exercise price change to become based on the listing price and valuation of the AIM listing. One of the noteholders elected to receive their Tethys Warrants at the closing of the fundraising. The other noteholder shall receive their additional consideration 90 days from first commercial sale of hydrocarbons by Tethys.

The requisite holders of the Senior Secured Notes, Senior Subordinated Notes and 12% Notes provided their consent to the Tethys Bridge as required under their respective Note Purchase Agreements.

The Tethys NPA, Tethys Notes, Tethys Warrants and the Warrant Instrument are governed by English law.

The Company evaluated the additional consideration for advancing its loan to Tethys 90 days after first commercial sale of hydrocarbons by Tethys for potential derivative treatment and determined it did not meet the criteria for bifurcation under SFAS No 133 Accounting for Derivative Instruments and Hedging Activities during the quarter.

Pursuant to EITF 98-5 Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and EITF 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments , the Company has recorded a discount to the Tethys Notes in the amount of approximately \$2,220,000 based on the relative fair value of the Tethys Warrants.

We used the following assumptions to determine the fair value of the Tethys Warrants:

	Additional Loan
Stock price on date of grant	\$ 0.74
Risk free rate of interest	4.73%
Expected life of warrant months	60
Dividend rate	
Historical volatility	110.5%

The discount is being amortized to interest expense over the life of the Tethys Warrants using an effective interest rate of 18.7%. As of September 30, 2006 we had amortized \$63,873 of debt discount as interest expense. The total effective interest rate for the Tethys Note is 32.9%.

**13 Accrued Liabilities**

Accrued liabilities consisted of the following at September 30, 2006 and December 31, 2005:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Drilling contractors	\$5,140,859	\$4,984,261
Professional fees	661,801	1,005,000
Other	1,300,029	367,362
	<b>\$7,102,689</b>	<b>\$6,356,623</b>

**Table of Contents**

Included in the amounts due to drilling contractors at September 30, 2006 are amounts invoiced by WEUS Holding Inc ( WEUS ) a subsidiary of Weatherford International Ltd. totalling \$4,931,332. We have formally notified WEUS that we dispute the validity of certain billings to the Company for work WEUS performed in the first and second quarter of 2005. We have recorded all amounts billed by WEUS as of September 30, 2006 pending the outcome of the dispute resolution which may require referral to the London Court of International Arbitration for resolution in accordance with the provisions of the contract.

14 Stockholders' Equity

	Common Stock					
	Number of Shares Issued and Issuable	Par Value	Additional Paid-In Capital	Deferred Compensation Expense	Accumulated Deficit	Total Stockholders Equity
<b>Total, December 31, 2005</b>	<b>222,586,867</b>	<b>\$22,258,685</b>	<b>\$202,892,303</b>	<b>\$(2,220,399)</b>	<b>\$(117,201,506)</b>	<b>\$105,729,083</b>
Shares Issued pursuant to amended loan agreement dated August 27, 2004. (Salahi Ozturk)	1,521,739	152,174	897,826			1,050,000
Adoption of FAS 123R stock based compensation on effective date			(2,220,399)	2,220,399		
Discount recorded for Beneficial conversion feature and Issue of warrants to purchase 13 million shares persuant to a convertible loan agreement			10,166,000			10,166,000
Discount recorded for Beneficial conversion feature and Issue of warrants to purchase 12.5 million			2,700,000			2,700,000

shares pursuant to  
a convertible loan  
agreement

Stock based  
compensation  
under SFAS  
123R

1,672,651

1,672,651

Options with  
redemption  
feature

(1,779,550)

(1,779,550)

Discount  
recorded for Issue  
of warrants to  
purchase  
5 million shares  
pursuant to a loan  
agreement

2,220,000

2,220,000

Exercise of stock  
options

774,000

77,400

511,700

589,100

Net Loss

(13,882,295)

(13,882,295)

**Total,  
September 30,  
2006**

**224,882,606****\$22,488,259****\$217,060,531****\$****0****\$(131,083,801)****\$108,464,989**

On February 14, 2006 we exercised the option forcing conversion of the loan from Salahi Ozturk advanced pursuant to the amended and restated loan and warrant agreement dated August 27, 2004 into 1,521,739 shares of our common stock.

#### 15 Net Income (Loss) Per Common Share

Earnings (loss) per share is calculated in accordance with SFAS No. 128, Earnings Per Share. Basic and diluted earnings per share are provided for continuing operations, discontinued operations and net income (loss). Basic earnings (loss) per share is computed based upon the weighted average number of shares of common stock outstanding for the period and excludes any potential dilution. Diluted earnings per share reflect potential dilution from the exercise of securities (warrants, options and convertible debt) into common stock. Outstanding options and warrants to purchase common stock are not included in the computation of diluted loss per share because the effect of these instruments would be anti-dilutive for the loss periods presented.



**Table of Contents**

Basic and diluted net loss per common share for the nine month periods ended September 30, 2006 and September 30, 2005 were based on the weighted average number of common shares outstanding during those periods. Convertible debt, options and warrants to purchase CanArgo's common stock outstanding during the nine months ended September 30, 2006 were not included in the computation of diluted net loss per common share because the effect of such inclusion would have been anti-dilutive. The total numbers of such shares excluded from diluted net loss per common share were 97,375,214 for the nine months ended September 30, 2006 and 41,255,621 for the nine months ended September 30, 2005. The total numbers of such shares excluded from diluted net loss per common share exclude any Tethys Warrants that may be issued to the holders of the Tethys Notes.

**16 Commitments and Contingencies**

We have contingent obligations and may incur additional obligations, absolute and contingent, with respect to the acquisition and development of oil and gas properties and ventures in which we have interests that require or may require us to expend funds and to issue shares of our Common Stock.

At September 30, 2006, we had the contingent obligation to issue an aggregate of 187,500 shares of our Common Stock to Fielden Management Services PTY, Ltd (a third party management services company), subject to the satisfaction of conditions related to the achievement of specified performance standards by the Stynawske Field project, an oil field in Ukraine in which we had a previous interest.

Under the Production Sharing Contract for Blocks XI<sup>G</sup> and XI<sup>H</sup> (the "Tbilisi PSC") in Georgia our subsidiary CanArgo Norio Limited had a commitment to acquire additional seismic data within three years of the effective date of the contract which is September 29, 2003. The State Agency for Oil & Gas Regulation in Georgia has consented to an extension to the period within which the data should be acquired to the end of 2007 and we are currently working with the State Agency to amend the Tbilisi PSC accordingly. The total commitment over the remaining period is \$350,000.

On June 28, 2006, the Company entered into a Conversion Agreement with the holders of the Senior Subordinated Notes (see note 12). As an inducement for the note holders to convert the Senior Subordinated Notes into Tethys common stock, the Company agreed to issue the Note holders 13,000,000 warrants ( "Compensation Warrants") to purchase CanArgo common stock at an exercise price of \$1.00 per common share. The Company will recognize the fair market value of the Compensation Warrants as of the date of the Conversion Agreement as an expense at the time of the conversion of the Senior Subordinated Notes. Had the Conversion Agreement been effective as of June 30, 2006, the Company would have recorded compensation from the Compensation Warrants of \$3,827,200 based on a valuation using the Black-Scholes model.

In 2002, the Participation Agreement for the three well exploration program on the Ninotsminda /Manavi area with AES Gardabani (a subsidiary of AES Corporation) ( "AES") was terminated without AES earning any rights to any of the Ninotsminda / Manavi area reservoirs. We therefore have no present obligations in respect of AES. However, under a separate Letter of Agreement, if gas from the Sub Middle Eocene is discovered and produced from the exploration area covered by the Participation Agreement, AES will be entitled to recover at the rate of 15% of future gas sales from the Sub Middle Eocene, net of operating costs, approximately \$7,500,000, representing their prior funding under the Participation Agreement.

On February 4, 2005, NOC and PFG agreed to terminate the Sales Agreement and enter into a new agreement ( "New Agreement") whereby PFG would receive an immediate repayment of its Security Deposit and obtain an extended term over which it can purchase crude oil produced from the Ninotsminda Field while NOC receives better commercial terms for the sale of its production. The New Agreement has a minimum term of 45 months and contains the following principal terms:

- (i) NOC will make available to PFG NOC's entire share of production from the Ninotsminda Field including a minimum total amount of 68,555 metric tonnes (the "Minimum Contract Quantity"). In the event NOC fails to produce the Minimum Contract Quantity it will have no liability to PFG;

**Table of Contents**

- (ii) The delivery point shall be at Georgian Oil's storage reservoirs at Samgori (adjacent to the Ninotsminda Field);
- (iii) The price for the oil will be in US Dollars per net US Barrel equal to the average of the mean of three quotations in Platts Crude Oil Marketwire<sup>®</sup> for Brent Dated Quotations minus a discount: ranging for sales (a) up to the Minimum Contract Quantity from \$6.00 to \$7.50 based on Brent prices per barrel ranging from less than \$15.00 to greater than \$25.01, respectively; and (b) for sales of oil in excess of the Minimum Contract Quantity at the commercial discount in Georgia for oil of similar quality less \$0.10 per barrel with the maximum discount being \$6.00 per barrel for export sales and \$5.50 per barrel for local sales; and
- (iv) PFG will pay NOC for the monthly quantity of oil in advance of delivery.

NOC's obligations are subject to customary Force Majeure provisions, title and risk of loss pass to buyer at the delivery point, NOC agrees to assist the buyer to sell the oil locally or export oil in accordance with applicable law and the New Agreement is governed by English law.

The last two oil sales concluded by NOC were to third party buyers as PFG was not able to comply with the terms of the New Agreement.

In September 2004, a blow-out occurred at the N100 well on the Ninotsminda Field. The Company currently estimates that the total costs attributable to the blow-out, including compensation and cleaning of the environment will be \$2,000,000. The Company's insurance policies cover 80% of these costs up to a maximum of \$2,500,000 and the remaining 20% insurance retention being payable by the Company. On June 3, 2005 we received \$800,000, as a first instalment, from our insurance company.

On July 27, 2005, GBOC Ninotsminda, an indirect subsidiary of the Company, received a claim raised by certain of the Ninotsminda villagers (listed on pages 1 to 76 of the claim) in the Tbilisi Regional Court in respect of damage caused by the blowout of the N100 well on the Ninotsminda Field in Georgia on September 11, 2004. An additional claim was received in December 2005 thus bringing the relief sought pursuant to both claims to the sum of 32.4 million GEL (approximately \$18.7 million at the exchange rate of GEL to US dollars in effect on September 30, 2006). At a hearing in March 2006 the plaintiffs increased the amount of damages sought to 50,000 GEL (approximately \$29,000) per plaintiff, which increased the total claim to approximately \$182,000,000. We believe that we have meritorious defences to this claim and intend to defend it vigorously.

On September 12, 2005, WEUS lodged a formal Request for Arbitration with the London Court of International Arbitration against CanArgo Energy Corporation in respect of unpaid invoices for work performed under the Master Service Contract dated June 1, 2004 between the Company and WEUS for the supply of under-balanced coil tubing drilling equipment and services during the first and second quarter of 2005. Pursuant to the Request for Arbitration, WEUS' demand for relief is \$4,931,332. Although the Company has recorded all amounts billed by WEUS as of December 31, 2005 (see Note 13) the Company is contesting the claim and has filed a counterclaim. We believe that we have meritorious defences to this claim and intend to defend it vigorously.

Under the Ninotsminda PSC, NOC is required to relinquish at least half of the area then covered by the production sharing contract, but not in portions being actively developed, at five year intervals commencing December 1999. In 1998, these terms were amended with the initial relinquishment being due in 2008 and a reduction in the area to be relinquished at each interval from 50% to 25% whereby the Contractor selects the relinquishment portions.

The Norio (Block XI C) and North Kumisi Production Sharing Agreement (Norio PSA) in which CanArgo Norio Limited currently owns a 100% interest, may be reduced to 85% should the state oil company, Georgian Oil, exercise an option available to it under the PSA for a limited period following the submission of a field development plan. As a contractor party, Georgian Oil would be liable for all costs and expenses in relation to any interest it may acquire in the PSA. This PSA covers an area of approximately 260,443 acres (1,054 km<sup>2</sup>).

**Table of Contents**

Our 2004 Long-Term Stock Incentive Plan, as amended ( 2004 Plan ) allows for up to 17,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. Stock options may be exercised, in whole or in part, by giving written notice of exercise to the Company specifying the number of shares to be purchased. However, in the event of a Change of Control (as defined in the 2004 Plan) an optionee (other than an optionee who initiated a Change of Control in a capacity other than as an officer or director of the Company ) may elect to surrender all or part of the stock option to the Company and to receive in cash an amount equal to the amount by which the fair market value per share of the Stock on the date of exercise shall exceed the purchase price per share under the stock option multiplied by the number of shares of the Stock granted under the stock option as to which the right granted by this proviso shall have been exercised. At the annual meeting of stockholders held on May 9, 2006, stockholders approved an increase to the number of shares issuable as incentive stock based compensation under the 2004 Plan by 7,500,000 shares from an original 10,000,000 shares to 17,500,000 shares. As of September 30, 2006, options to acquire an aggregate of 7,642,000 shares of common stock had been granted under this Plan and were outstanding, 6,379,000 of which are currently vested.

At September 30, 2006 our Kazakhstan subsidiary, BN Munai LLP, had entered into contracts with Tip-Top International Development Limited and RemSpetsTekhKran LLP totalling approximately \$9,000,000 for the purchase and construction of pipeline, infield lines and compressors for the delivery of gas into the main Bukhara Urals gas trunkline. Payments of approximately \$4,426,000 have been made to September 30, 2006 in connection with these contracts.

Lease Commitments We lease office space under non-cancellable operating lease agreements.

**17 Options with Redemption Feature**

Our 2004 Plan, as amended, allows for up to 17,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. Stock options may be exercised, in whole or in part, by giving written notice of exercise to the Company specifying the number of shares to be purchased. However, in the event of Change of Control (as defined in the 2004 Plan) an optionee (other than an optionee who initiated a Change of Control in a capacity other than as an officer or director of the Company) may elect to surrender all or part of the stock option to the Company and to receive in cash an amount equal to the amount by which the fair market value per share of the stock on the date of exercise shall exceed the purchase price per share under the stock option multiplied by the number of shares of the stock granted under the stock option as to which the right granted by this proviso shall have been exercised.

Under SEC Accounting Series Release 268 Presentation in Financial Statements of Redeemable Preferred Stocks , the Company has calculated and classified the intrinsic value of \$3,899,080 as at September 30, 2006 and \$2,119,530 as at December 31, 2005 to Temporary Equity, being the vested portion of issued share options from our 2004 Long-Term Incentive Plan in accordance with the related guidance.

**18 Discontinued Operations****Samgori PSC**

On February 17, 2006 we issued a press release announcing that our subsidiary, CanArgo Samgori Limited ( CSL ), was not proceeding with further investment in Samgori (Block XI<sup>B</sup>) Production Sharing Contract ( Samgori PSC ) in Georgia and associated farm-in which became effective in April 2004, and accordingly we terminated our 50% interest in the Samgori PSC with effect from February 16, 2006. The decision by CSL not to proceed with further investment under the current farm-in arrangements was due to the inability of CSL's partner in the project, Georgian Oil Samgori Limited ( GOSL ), to provide its share of funding to further the development of the Field. We consider that there would have been insufficient time to meet the commitments under the Agreement with National Petroleum Limited ( NPL ) the previous licence holders and we were not prepared to fund the project, which is not without risk, on a 100% basis without different commercial terms and an extension to the commitment period. It was not possible to negotiate a satisfactory position on either matter. CSL has been informed that NPL has now exercised its right to take back



**Table of Contents**

100% of the Contractor Share in the Samgori PSC from GOSL and, accordingly, effective February 16, 2006 we have withdrawn from the Samgori PSC.

The results of discontinued operations in respect of CSL consisted of the following for the nine month periods ended:

	<b>September 30, 2006 (Unaudited)</b>	September 30, 2005 (Unaudited)
Operating Revenues	\$ 1,002,842	\$ 1,216,017
Income Before Income Taxes and Minority Interest	763,419	444,649
Income Taxes		
Minority Interest in Income		
Net Income from Discontinued Operation	\$ 763,419	\$ 444,649

The results of discontinued operations in respect of CSL consisted of the following for the three month periods ended:

	<b>September 30, 2006 (Unaudited)</b>	September 30, 2005 (Unaudited)
Operating Revenues	\$	\$
Loss Before Income Taxes and Minority Interest	(18,154)	(139,590)
Income Taxes		
Minority Interest in Income		
Net Loss from Discontinued Operation	\$ (18,154)	\$ (139,500)

Gross consolidated assets and liabilities in respect of CSL that are included in assets to be disposed consisted of the following at September 30, 2006 and December 31, 2005:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Unaudited)
Assets to be disposed:		
Accounts receivable (net)	\$ 343	\$ 1,414
Other current assets	6,654	3,698
	\$ 6,997	\$ 5,112
Liabilities to be disposed:		
Accounts payable	\$ 357,126	\$ 483,438

Deposits		528
Provision for future site restoration	290,250	270,000
	\$ 647,376	\$ 753,966

The Company is reviewing whether NPL s actions have released it from its asset retirement obligations.

3-megawatt dual fuel power generator

In 2003, we signed a sales agreement disposing of a 3-megawatt dual fuel power generator for \$600,000 and have received a non-refundable deposit of approximately \$300,000. The

**Table of Contents**

unit was shipped to the United States where it underwent tests in late 2004. On completion of these tests to the satisfaction of the buyer, we were to transfer title for this equipment and receive the final payment of \$300,000. Although the unit was successfully tested, the buyer failed to meet the sale contract terms resulting in the loss of its deposit in the third quarter, 2005. We are currently remarketing the generator.

The generator has been classified as Assets held for sale for all periods presented. The amount reflects what the Company believe to be its fair value less cost to sell. Gross consolidated assets in respect of the generator included in Assets held for sale consisted of the following at September 30, 2006 and December 31, 2005:

	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)
Assets held for sale:		
Capital assets, net	\$ 600,000	\$ 600,000
	<b>\$ 600,000</b>	<b>\$ 600,000</b>

**19 Segment and Geographical Data**

The segment and geographical data below is presented for the nine and three month periods ended September 30, 2006.

Operating revenues from continuing operations for the nine month period ended September 30, 2006 by geographical area were as follows:

	<b>September 30, 2006 (Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 4,092,224
Republic of Kazakhstan	
Total	<b>\$ 4,092,224</b>

Operating revenues from continued operations for the three month period ended September 30, 2006 by geographical area were as follows:

	<b>September 30, 2006 (Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 2,090,147
Kazakhstan	
Total	<b>\$ 2,090,147</b>

**Table of Contents**

Operating income (loss) from continuing operations for the nine month period ended September 30, 2006 by geographical area was as follows:

	<b>September 30, 2006 (Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 843,221
Kazakhstan	(2,493,966)
Corporate and Other Expenses	(8,810,315)
Total Operating Loss	\$ (10,461,060)

Operating income (loss) from continued operations for the three month period ended September 30, 2006 by geographical area was as follows:

	<b>September 30, 2006 (Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 1,052,422
Kazakhstan	(1,309,649)
Corporate and Other Expenses	(3,234,968)
Total Operating Loss	\$ (3,492,195)

Net (loss) income before minority interest from continuing operations for the nine month period ended September 30, 2006 by geographical area was as follows:

	<b>September 30, 2006 (Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 843,221
Kazakhstan	(2,493,966)
Corporate and Other Expenses	(12,994,969)
Net (Loss) Income Before Minority Interest	\$ (14,645,714)

Net (loss) income before minority interest from continuing operations for the three month period ended September 30, 2006 by geographic area was as follows:

**September 30,**



	<b>2006</b> <b>(Unaudited)</b>
Oil and Gas Exploration, Development and Production	
Georgia	\$ 1,052,422
Kazakhstan	(1,309,649)
Corporate and Other Expenses	(5,442,736)
Net (Loss) Income Before Minority Interest	(5,699,963)

**Table of Contents**

Identifiable assets of continuing and discontinued operations as of September 30, 2006 and December 31, 2005 by business segment and geographical area were as follows:

	<b>September 30, 2006 (Unaudited)</b>	<b>December 31, 2005 (Unaudited)</b>
Corporate		
Georgia	\$ 309,182	\$ 785,607
Western Europe (principally cash)	25,894,739	27,725,366
Total Corporate	26,203,921	28,510,973
Oil and Gas Exploration, Development and Production		
Georgia	120,928,700	106,905,404
Kazakhstan	16,797,255	11,426,813
Assets to be disposed Georgia	6,997	5,112
Assets Held for Sale Western Europe	600,000	600,000
Total Identifiable Assets	\$ 164,536,873	\$ 147,448,301

**20 Subsequent Events**

On October 13, 2006, we announced the completion of a private placement in Norway of an aggregate of 12,263,368 shares of common stock at a purchase price of NOK 9.10 per share, for aggregate gross proceeds of NOK 111,596,239 (\$16,687,039 equivalent based upon a conversion rate of NOK 6.6876 per dollar) before placing fees and expenses estimated at NOK 6,695,774 (\$1,001,022). The shares were issued in a transaction intended to qualify for the exemption from registration afforded by Section 4(2) of the Securities Act and Regulation S promulgated thereunder. Under the terms of the transaction, CanArgo agreed to register the Shares for resale under the Securities Act and the Company filed a Registration Statement on Form S-3 with the SEC on October 13, 2006 which included these shares. As at November 9, 2006 the Registration Statement on Form S-3 has not been declared effective. As a result of the delays incurred in registering the Shares we have paid subscribers a cash liquidity penalty of 5% of the subscription price of their Shares in the aggregate amount of NOK 5,579,812 (\$834,352 equivalent). The net proceeds of the placement will be used by the Company for working capital; future capital expenditures in Georgia, including, without limitation, securing drilling equipment; and other related activities.

On October 10, 2006 we announced that our wholly owned subsidiary responsible for our Kazakhstan assets, Tethys Petroleum Limited ( Tethys ), has progressed its plans to seek admission to the Alternative Investment Market ( AIM ) of the London Stock Exchange and raise capital in connection with this admission.

In connection with the planned admission of Tethys to AIM the Company announced on October 10, 2006 that Vincent McDonnell, currently the Company's President, will succeed David Robson as Chief Executive Officer of CanArgo once the AIM admission of Tethys is complete.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Qualifying Statement With Respect To Forward-Looking Information**

*THE FOLLOWING INFORMATION CONTAINS FORWARD-LOOKING STATEMENTS. SEE FORWARD-LOOKING STATEMENTS BELOW AND ELSEWHERE IN THIS REPORT.*

In addition to the historical information included in this report, you are cautioned that this Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When the words believes, plans, anticipates, will likely result, will continue, projects, expects, and similar expressions in this Form 10-Q, they are intended to identify forward-looking statements, and such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. Furthermore, our plans, strategies, objectives, expectations and intentions are subject to change at any time at the discretion of management and the Board.

These forward-looking statements speak only as of the date this report is filed. The Company does not intend to update the forward-looking statements contained in this report, so as to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as may occur as part of our ongoing periodic reports filed with the SEC.

The following is a discussion of our financial condition, results of operations, liquidity and capital resources. This discussion should be read in conjunction with our consolidated annual financial statements and the notes thereto, included in our Annual Report on Form 10-K filed for the year ended December 31, 2005 in addition to our condensed consolidated quarterly financial statements and the notes thereto, included in Item 1 of this report.

***Overview***

Our share of the 134,593 (493 barrels per day) of gross oil production from the Ninotsminda Field in Georgia for the nine month period ended September 30, 2006 was 87,485 barrels. For the nine month period ended September 30, 2005 our share of the 138,319 (507 barrels per day) of gross oil production from the Ninotsminda Field was 89,907 barrels.

During the third quarter 2006, we continued to progress our exploration, appraisal and development plans in both of our areas of operation, Georgia and Kazakhstan.

***Georgia***

The N97H well was drilled and completed in March 2006 as a horizontal development well on the Ninotsminda Field. It targeted oil volumes un-drained from previous offset area wells and was put on production test following the installation of a slotted liner over a 1,509 feet (460 metres) interval furthest from the heel of the well. The well produced initially with a high water cut, approximately 70%, and an oil rate which peaked at 385 barrels of oil per day (bopd) before declining. Subsequent pressure surveys run with downhole gauges suggested that the N97H well was in communication with the offset N4H well. The most likely assumed scenario was then some of the fracture sets encountered at the end of the N97H well were drained by the N4H well and were hence water filled. Once a very high permeability connection is established with the aquifer, water will flow in preference to any oil filled fractures or matrix of lower permeability.

On the basis of the test data and due to the fact that the N97H well is approximately 36 feet (11 metres) structurally higher than the N4H well which is still producing oil, it was decided to attempt to conduct remedial water isolation. The slotted liner deployed in the horizontal section limited mechanical options for shutting off the toe end of the horizontal section. Previous experience in the field has shown that pulling a liner once set has a very low chance of success due to formation collapse around the liner. Also, as a traditional cement isolation was considered to have a low chance of success in a horizontal section, a coiled tubing deployed chemical shut-off was opted for. Water isolation operations were conducted during the summer months but subsequent production testing showed that the treatment was not successful.

**Table of Contents**

We now plan to set a cement retainer in the solid liner section of the N97H well in order to isolate and abandon the slotted liner part. The liner through the gas cap will then be perforated and the well converted to a potential gas producer. The build up and heel section of the well is in a crestal location on the field and there has been little previous offset well gas cap production. Materials have been ordered for this operation but will not be available for about four to six weeks.

On October 8, 2006 we announced that the Manavi M12 appraisal well which is drilling in Georgia had been drilled to a total depth of 16,345 feet (4,892 metres) in the Cretaceous reservoir when it was decided to log the well and run 7 inch casing, however, whilst conditioning the well prior to these operations, the drill pipe became pressure differentially stuck at 13,796 feet (4,205 metres). Subsequent efforts to release the drill pipe were not successful and in order to progress drilling activities it was necessary to detach the stuck portion of the drill pipe and set a cement plug over the fish prior to sidetracking the well from the open hole section in the same diameter hole.

Using directional drilling equipment and services provided by Baker-Hughes, the well has been sidetracked in an 8 1/2 inch hole to a depth of 15,360 feet (4,682 metres) close to the top of the higher pressure and more porous / permeable reservoir interval in the upper Cretaceous where a major hydrocarbon influx was observed in the original well bore. A 7 inch casing has been run and cemented at this level so as to isolate the zone where the differential sticking occurred. Once the 7 inch casing has been tied back to surface, we plan to drill ahead in a 6 1/2 inch hole for approximately 230 feet (70 metres) through the more porous reservoir zone and then perform an open hole drill stem test (DST) on this interval. The DST would provide information on reservoir pressure, fluid type and flow rate before drilling ahead to the planned total depth (TD) of approximately 16,732 feet (5,100 metres). We expect to be doing this test towards the end of November and to reach the planned TD in the second half of December. Once the well has reached TD we would plan to run electric logs to confirm the presence of hydrocarbons prior to casing the well and on demobilising the rig test any additional intervals and conduct long term production testing as necessary.

In the original M12 well bore, 919 feet (280 metres) of Cretaceous carbonate reservoir section was penetrated. Hydrocarbon shows were detected throughout the entire Cretaceous interval with a strong gas kick observed and significant shows recorded. At the same time, traces of light oil/condensate were observed in the drilling mud. These strong shows were associated with a more fractured porous vuggy white limestone interval which was also encountered in the M11 well. No evidence of an hydrocarbon-water contact has been identified in the well which has been drilled to a deeper level than the previous wells, thus indicating a potential total hydrocarbon column in the structure in excess of 1,870 feet (570 metres). There is further reservoir potential identified in the overlying Palaeocene which is a continuation of the Cretaceous limestone stratigraphy and in the Middle Eocene sequence both of which had hydrocarbon shows.

The primary target of the Norio MK72 exploration well was the Middle Eocene fractured volcanoclastic reservoir. The well reached a total depth of 16,076 feet (4,900 metres) with oil and gas shows encountered in the Middle Eocene and with associated mud losses thus suggesting a permeable reservoir. Before the well could be drilled to the planned depth and tested, the bottom hole assembly (BHA) became stuck due to hole collapse. Subsequent attempts to retrieve the BHA were not successful and we decided to abandon the lower target due to a limited chance of sidetracking the well at this depth in a small diameter hole and to focus our attention on the shallower discovery in the overlying Oligocene sands.

A total of 322 feet (98 metres) of net sands in the Oligocene formation were perforated over the interval 12,096 feet (3,687 metres) to 13,622 feet (4,152 metres). These sands, which formed a secondary target in the well, had good oil shows whilst drilling, with oil to surface and with hydrocarbons being interpreted on the electric logs which also indicated a substantial thickness of net pay sands. Following an extensive testing programme, the well sustained flow on a small choke size with low average gross fluid rates of approximately 13 barrels per day consisting of light 48.6°API oil, gas and water.

A number of surge clean up flows, a re-perforation of selected intervals, and a low pressure hydrofrac using our own pumping unit have been attempted but these have not improved reservoir deliverability. It is believed that the current flow is limited to a thinner, less permeable, interval whilst the better quality reservoir remains isolated due to reservoir damage caused by the invasive fluid damage of the drilling mud. The lower zones in the well, which would have been in communication with the Oligocene interval through the well bore, were drilled with a 1.9 to 2.2 Specific

Gravity (SG) mud due to anticipated reservoir pressures while the results from the testing programme indicate that the mid interval reservoir pressure for the Oligocene whilst still over pressured, is lower at 1.7 SG

**Table of Contents**

equivalent. As a result of possible mud damage, the current perforations may have not penetrated deep enough beyond the damaged zone to allow proper communication between the more permeable formations and the well bore.

We considered mobilising a more powerful frac pump to Georgia in order to pump a proppant and fluid into the well at high pressure and volume, but the potential for this technology is limited due to a lack of a cement bond behind the casing and the large interval which has been perforated. The well has been left on test production for the past several months but there has been no discernable increase in gross fluid production rate. As we would appear to have exhausted all the low cost options available to us at this time to bypass any damage that may exist in the near-well bore area and establish better communication between the well bore and the reservoir, we believe that the only effective option remaining is to sidetrack the well or to drill a new well. The latter, of course, would enable us to attempt to test both the Oligocene and Middle Eocene intervals both of which are considered to have significantly reduced geological risk. We are now planning to temporarily abandon the well and mobilise the CanArgo rig #2 to the Kumisi location in preparation for the planned spud of the Kumisi #1 well before the end of December 2006 subject to all permissions and permits being obtained.

The Kumisi #1 well is being drilled to appraise the large Kumisi gas prospect which is located approximately 9 miles (15 km) south of the city of Tbilisi. The nearby WR16 well, drilled in Soviet times, is reported to have tested gas at rates of up to 1.24 MMscf (35 MCM) per day and water from the Cretaceous sequence at what is interpreted to be the gas-water contact. Additional seismic data acquired by us over the area and subsequent interpretation and mapping has identified a very significant prospect up-dip of the WR16 well with the principal risk being closure on the structure. The Kumisi #1 well is being located so as to test the structure up-dip of the WR16 gas discovery.

Gas sales from the Ninotsminda Field under the agreement concluded in June 2006 between Ninotsminda Oil Company Limited (NOC), and Georgian Oil, the state oil company, as the seller parties and Georgian Gas Transportation Company, the state owned gas transmission company, as the buyer is expected to commence in mid-November. The buyer in turn will deliver the gas to the state owned Gardabani gas fired thermal power plant once it has completed repairs to the 25 mile (41 kilometres) pipeline between Ninotsminda and Gardabani. The initial planned quantity of gas to be supplied under the agreement is 7.06 MMscf (200 MCM) per day.

*Kazakhstan*

In Kazakhstan, work is proceeding on the Kyzylai Gas Field development program. Purchase orders have been placed for pipe for the 32 mile (52 km) export pipeline, infield lines and the compressors necessary to pressure up the gas for delivery into the main Bukhara - Urals gas trunkline. Delivery of the pipe has commenced. Construction work has already commenced and the compressors are due to be delivered in January 2007. The initial Kyzylai development involves production from eight already tested gas wells on the Kyzylai and NE Kyzylai Fields, with the subsequent addition of recent exploration discoveries. First gas is expected in Q1 2007 with an initial planned rate of approximately 22 MMscf (625 MCM) of gas per day.

Work is also proceeding on further exploration for shallow gas in the Akkulka exploration area around the Kyzylai Field. A contract has now been awarded to drill five further exploration / appraisal wells on identified shallow gas prospects and drilling is already underway on the first of these wells. Plans are also underway to commence a deeper exploration drilling program in early 2007 targeting potential oil prospects in the Akkulka area, subject to funding being available.

On October 10, 2006 we announced that our wholly owned subsidiary responsible for our Kazakhstan assets, Tethys, has progressed its plans to seek admission to the Alternative Investment Market ( AIM ) of the London Stock Exchange and raise capital in connection with this admission.

Depending on pricing and on market conditions, Tethys now plans to seek admission to AIM by the end of 2006. Tethys has engaged ODL Securities Limited in connection with this transaction and Nabarro Wells & Co. Ltd who are the nominated advisor.

The funds to be raised through the AIM listing are currently intended to be used primarily to advance the development of the Kyzylai Gas Field and further exploration and development plans for the Akkulka and Greater Akkulka contract areas.

It is currently planned, subject to progressing with the AIM admission, that CanArgo will retain a significant, but not controlling, equity interest in Tethys after the admission of Tethys to the AIM market.

**Liquidity and Capital Resources**

As of September 30, 2006 we had working capital of \$14,328,000, of which approximately \$300,000 was restricted cash, compared to working capital of \$14,808,000 as of December 31, 2005 of which approximately \$3.2 million was restricted cash.

**Table of Contents**

On July 25, 2005, we announced that we had closed the private placement of a \$25,000,000 issue of Senior Secured Notes due July 25, 2009 with a group of investors arranged through Ingalls & Snyder LLC of New York City.

The proceeds of this financing, after the payment of all professional and placing expenses and fees estimated at \$350,000, have been used to redeem short term debt and accrued interest in the amount of approximately \$7,400,000 under the Promissory Note with Cornell Capital, to fund the appraisal of a new gas project in Georgia, to fund the development of the Kyzylloi Gas Field in Kazakhstan and adjacent exploration areas, and for additional working capital for our development, appraisal and exploration activities in Georgia. In addition, we terminated the SEDA which we had with Cornell Capital with effect as of August 24, 2005.

See Note 12 to the financial statements included herein for a description of the terms and conditions of the Senior Secured Notes.

On March 3, 2006, we finalised a private placement with a limited group of investors arranged by Ingalls & Snyder LLC of New York City of a \$13,000,000 issue of Senior Subordinated Convertible Guaranteed Notes due September 1, 2009 (the Senior Subordinated Notes ) and warrants to purchase an aggregate of 13,000,000 shares of our common stock ( Warrant Shares ) at an exercise price of \$1.37 per share, subject to adjustment, and expiring on March 3, 2008 or sooner under certain circumstances ( Warrants ).

The proceeds of this financing, after the payment of all placing expenses and professional fees estimated at \$150,000, will be used exclusively to fund the development of the Kyzylloi Gas Field in Kazakhstan and on the commitment exploration programs in Kazakhstan through Tethys, the wholly owned subsidiary of CanArgo which holds CanArgo's Kazakhstan assets.

See Note 12 to the financial statements included herein for a description of the terms and conditions of the Senior Subordinated Notes and associated Warrants.

On June 28, 2006, we announced that we had entered into the private placement with Persistency of a \$10,000,000 issue of a 12% Subordinated Convertible Guaranteed Note due June 28, 2010 (the 12% Note ) and warrants to purchase an aggregate of 12,500,000 shares of CanArgo common stock ( Warrant Shares ), at an exercise price of \$1.00 per share, subject to adjustment, and expiring on June 28, 2008 or sooner under certain circumstances (the 12% Note Warrants ).

The proceeds of this financing, after the payment of all placing expenses and professional fees (estimated at \$150,000), will be used to fund our appraisal and development activities in Georgia including further development of the Ninotsminda Field and appraisal of the Kumisi gas discovery.

See Note 12 to the financial statements included herein for a description of the terms and conditions of the 12% Note and associated 12% Note Warrants.

On September 7, we announced that Tethys had completed a \$5 million interim loan financing (the Tethys Bridge ) to fund Tethys' development activities in Kazakhstan ahead of Tethys' planned spin-off and admission to the AIM market in London later this year. The funds are to be used by Tethys primarily for the purchase of pipeline, compressors and related equipment and services for the Kyzylloi field development. The financing took the form of the issue of \$5 million senior secured notes in Tethys redeemable on August 31, 2008 (the Tethys Notes ) pursuant to a note and warrant or royalty purchase agreement dated September 5, 2006 (the Tethys NPA ). Pursuant to the Tethys NPA, Tethys has the ability to pre-pay the Tethys Notes and the Tethys Notes fall to be automatically pre-paid in full following a change of control of Tethys which includes the admission of Tethys to AIM. Tethys has granted security over its bank account with HSBC Bank plc and its shareholding in its wholly owned subsidiary, Tethys Kazakhstan Limited, as a condition of the Tethys NPA with such security to be released on repayment of the funds. The Tethys Notes bear interest at the rate of 10% per annum for the period from the date of issue until December 31, 2006 and 15% per annum from January 1 2007 until they are repaid in full. The Tethys NPA contains certain affirmative and negative covenants on Tethys which apply provided at least \$500,000 in aggregate of the Tethys Notes is outstanding. The affirmative and negative covenants require Tethys among other things to maintain its corporate existence, to maintain insurance coverage on such terms and in such amounts as is customary in the case of entities in the same or similar businesses and which are similarly situated, to keep current with respect to payment of all due and payable taxes, to not permit Tethys to engage in transactions with affiliates unless they are in the ordinary course of business and on arm's length terms, to not enter into mergers or consolidations while an default or event of default is continuing



or to allow liens on

**Table of Contents**

any pledged or secured assets under the NPA except specified permitted liens. In addition, while the covenants still apply Tethys must seek the permission of the noteholders to incur additional external third-part indebtedness in excess of \$2,500,000 except permitted indebtedness as specified in the Tethys NPA.

Pursuant to the provisions of Emerging Issue Task Force 86-15: Increasing-Rate Debt, the Company recognizes interest expense using the effective interest rate method, which results in the use of a constant interest rate for the life of the Tethys Notes. The effective interest rate is approximately 14.2% per annum. The difference between the interest computed using the actual interest rate in effect (10% per annum to December 31, 2006 and 15% from January 1, 2007) and the effective interest rate (14.2% per annum) totalled \$14,222 as of September 30, 2006 and has been accrued as a non-current liability.

Under the terms of the Tethys NPA, the holders of the Tethys Notes are entitled to receive additional consideration for the advance of the loan in the form of either (1) at closing of the fundraising, warrants to subscribe for ordinary shares in the capital of Tethys (the Tethys Warrants) or (2) 90 days following first commercial sale of hydrocarbons, in which case Tethys may chose between granting the noteholder Tethys Warrants or entering into a royalty agreement with the noteholder. The Tethys Warrants shall be issued pursuant to the terms of an instrument by way of deed poll entered into by Tethys on September 5, 2006. The Tethys Warrants are exercisable in whole or in part at any time up to the expiry of 60 months from the date of the Tethys NPA. As of September 30, 2006, the number of ordinary shares in the capital of Tethys into which the Tethys Warrants are exercisable and the exercise price of the Tethys Warrants are based on an assumed valuation of Tethys, however, in the event of an AIM listing prior to July 31, 2007 the number of shares and exercise price change to become based on the listing price and valuation of the AIM listing. One of the noteholders elected to receive their Tethys Warrants at the closing of the fundraising. The other noteholder shall receive their additional consideration 90 days from first commercial sale of hydrocarbons by Tethys.

The requisite holders of the Senior Secured Notes, Senior Subordinated Notes and 12% Notes provided their consent to the Tethys Bridge as required under their respective Note Purchase Agreements.

The Tethys NPA, Tethys Notes, Tethys Warrants and the Warrant Instrument are governed by English law.

On October 13, 2006, we announced the completion of a private placement in Norway of an aggregate of 12,263,368 shares of common stock at a purchase price of NOK 9.10 per share, for aggregate gross proceeds of NOK 111,596,239 (\$16,687,039 equivalent based upon a conversion rate of NOK 6.6876 per dollar) before placing fees and expenses estimated at NOK 6,695,774 (\$1,001,022). The shares were issued in a transaction intended to qualify for the exemption from registration afforded by Section 4(2) of the Securities Act and Regulation S promulgated thereunder. CanArgo agreed to register the Shares for resale under the Securities Act and the Company filed a Registration Statement on Form S-3 with the SEC on October 13, 2006, which included these shares. As at November 9, 2006, the Registration Statement on Form S-3 has not been declared effective. As a result of the delays incurred in registering the Shares we have paid subscribers a cash liquidity penalty of 5% of the subscription price of their Shares in the aggregate amount of NOK 5,579,812 (\$834,352 equivalent). The net proceeds of the placement will be used by the Company for working capital; future capital expenditures in Georgia, including, without limitation, securing drilling equipment; and other related activities.

Cash flows from our Georgian operations together with the proceeds of the private placement of a \$25,000,000 issue of Senior Secured Notes, the \$13,000,000 issue of Senior Subordinated Notes, the \$10,000,000 issue of 12% Notes, the \$5,000,000 issue of Tethys Notes (all detailed above and collectively referred to herein as the Notes) and the net proceeds of the private placement in Norway means we have most of the working capital necessary to cover our immediate and near term funding requirements. In order to continue with all of our currently planned development activities in Georgia on our Ninotsminda Field and the appraisal of our Manavi oil discovery, and our exploration and development plans in the Republic of Kazakhstan, we are currently investigating further fundraising proposals. On June 28, 2006 we announced that Tethys is planning to seek admission to the AIM market of the London Stock Exchange and raise funds for its development and exploration activities in Kazakhstan (Tethys Spin-Out). We plan to retain a significant, but not controlling, equity interest in Tethys after the admission of Tethys to the AIM market. The intention is that this funding will enable



**Table of Contents**

the Kazakh assets to be financed whilst minimizing dilution for our shareholders and potentially raising additional funds for our operations. Tethys has engaged ODL Securities Limited to act as principal broker for this transaction, which is currently planned for the end of this year, subject to prevailing market conditions. The final decision on this Spin-Out will be made at that time, subject to pricing and other considerations.

While a considerable amount of infrastructure for the Ninotsminda Field has already been put in place, we cannot provide assurance that:

funding of a field development plan will be timely;

that our development plan will be successfully completed or will increase production; or

that field operating revenues after completion of the development plan will exceed operating costs.

Under the terms of each of the Note issues, we are restricted from incurring future indebtedness and from issuing additional senior or *pari passu* indebtedness, except with the prior consent of the Required Holders or in limited permitted circumstances. The definition of indebtedness encompasses all customary forms of indebtedness including, without limitation, liabilities for the deferred consideration, liabilities for borrowed money secured by any lien or other specified security interest, liabilities in respect of letters of credit or similar instruments (excluding letters of credit which are 100% cash collateralised) and guarantees in relation to such forms of indebtedness (excluding parent company guarantees provided by the Company in respect of the indebtedness or obligations of any of the Company's subsidiaries under its Basic Documents (as defined in the respective Note Purchase Agreements)). Pursuant to the terms of the Note Purchase Agreements, permitted future indebtedness is (a) indebtedness outstanding under the Notes; (b) any additional unsecured indebtedness, the aggregate amount outstanding thereunder at any time not exceeding certain specified amounts and; (c) certain unsecured intra-group indebtedness (in the case of Senior Secured Notes, Senior Subordinated Notes and 12% Notes this is limited to the indebtedness of a CanArgo Group Member (as defined in the Note Purchase Agreements) to a direct or indirect subsidiary of the Company which is not deemed to be a Material Subsidiary (under the Note Purchase Agreements the aggregate amount outstanding under the particular indebtedness shall not exceed certain specified levels at any time). See Note 12 to the financial statements included herein.

To pursue existing projects beyond our immediate appraisal and development plans and to pursue new opportunities, we may require additional capital. While expected to be substantial, without further exploration work and evaluation the exact amount of funds needed to fully develop all of our oil and gas properties cannot at present, be quantified. Potential sources of funds include additional sales of equity securities, project financing, debt financing and the participation of other oil and gas entities in our projects. Based on our past history of raising capital and continuing discussions, we believe that such required funds may be available. However, there is no assurance that such funds will be available, and if available, will be offered on attractive or acceptable terms. Should such funding not be forthcoming, we may not be able to pursue projects beyond our current appraisal and development plans or to pursue new opportunities. As discussed above, under the terms of the Notes, we are restricted from incurring additional indebtedness.

Development of the oil and gas properties and ventures in which we have interests involves multi-year efforts and substantial cash expenditures. Full development of our oil and gas properties and ventures may require the availability of substantial additional financing from external sources. We may also, where opportunities exist, seek to transfer portions of our interests in oil and gas properties and ventures to entities in exchange for such financing. We generally have the principal responsibility for arranging financing for the oil and gas properties and ventures in which we have an interest. There can be no assurance, however, that we or the entities that are developing the oil and gas properties and ventures will be able to arrange the financing necessary to develop the projects being undertaken or to support the corporate and other activities of CanArgo. There can also be no assurance that such financing will be available on terms that are attractive or acceptable to or are deemed to be in the best interest of CanArgo, such entities and their respective stockholders or participants.

Ultimate realization of the carrying value of our oil and gas properties and ventures will require production of oil and gas in sufficient quantities and marketing such oil and gas at sufficient prices to provide positive cash flow to

CanArgo. Establishment of successful oil and gas operations is dependent upon, among other factors, the following:

37

---

**Table of Contents**

mobilization of equipment and personnel to implement effectively drilling, completion and production activities; raising of additional capital; achieving significant production at costs that provide acceptable margins; reasonable levels of taxation, or economic arrangements in lieu of taxation in host countries; and the ability to market the oil and gas produced at or near world prices.

Subject to our ability to raise additional capital, above, we have plans to mobilize resources and achieve levels of production and profits sufficient to recover the carrying value of our oil and gas properties and ventures. However, if one or more of the above factors, or other factors, are different than anticipated, these plans may not be realized, and we may not recover the carrying value of our oil and gas properties and ventures.

**Balance Sheet Changes**

Cash and cash equivalents decreased \$1,207,000 from \$18,541,000 at December 31, 2005 to \$17,334,000 at September 30, 2006. The decrease was due to expenditures in the period to primarily fund the cost of preparing wells for our horizontal development program at the Ninotsminda Field the appraisal of our Manavi oil discovery in Georgia, activities in Kazakhstan and net cash used by operating activities partially offset by cash received pursuant to the Senior Subordinated Notes, the 12% Notes and the maturing of deposits previously recorded as restricted cash.

Restricted cash decreased from \$3,182,000 at December 31, 2005 to \$300,000 at September 30, 2006 due to the maturing of deposits funding letters of credit as required under the rig rental and drilling contract we entered into with Saipem, S.p.A.

Accounts receivable increased from \$413,000 at December 31, 2005 to \$916,000 at September 30, 2006 primarily due to an increase in insurance claim amounts receivable in connection with our Georgian exploration activities.

Crude oil inventory decreased to \$417,000 at September 30, 2006 from \$886,000 at December 31, 2005 primarily as a result of increased sales from storage in the period.

Prepayments increased from \$4,376,000 at December 31, 2005 to \$5,230,000 at September 30, 2006 as a result of timing differences in respect of prepayments for materials and services related to our appraisal activities at the Manavi oil discovery, our horizontal well development program at Ninotsminda and our Kazakhstan activities and an increase in insurance premiums prepaid. Upon receipt of the materials and services, those amounts will be transferred to capital assets. This increase is included in the statement of cash flows as an investing activity.

Investments of \$154,000 at September 30, 2006 consisted of bank deposits with maturity dates of more than 12 months.

Non current accounts receivables of \$375,000 at September 30, 2006 relate to VAT amounts recoverable from our Kazakhstan operations as an offset against VAT payable on future gas revenues.

Prepaid financing fees increased to \$472,000 at September 30, 2006 from \$247,000 at December 31, 2005 as a result of corporate finance fees incurred in respect of the \$13,000,000 issue of Senior Subordinated Notes due September 1, 2009, the \$10,000,000 issue of 12% Notes due June 28, 2010 and the \$5,000,000 issue of Senior Secured Notes redeemable 31 August 2008, by our wholly owned subsidiary, Tethys and which are to be amortized as interest over the term of the loans.

Capital assets net, increased to \$138,591,000 at September 30, 2006 from \$119,048,000 at December 31, 2005, due to investing in capital assets including oil and gas properties and equipment, principally related to the Ninotsminda Production Sharing Contract and the development of the Kazakhstan project.

Accounts payable decreased to \$2,867,000 at September 30, 2006 from \$5,271,000 at December 31, 2005 primarily due to timing differences in respect of payments to suppliers in connection with our appraisal activities at the Manavi oil discovery, our horizontal well development program at the Ninotsminda Field and our Kazakhstan activities.

**Table of Contents**

Loans payable decreased to \$0 at September 30, 2006 from \$964,000 at December 31, 2005 due to the repayment of the Loan with Detachable Warrants of \$1,050,000 on February 14, 2006 by exercising the option forcing conversion of the loan into 1,521,739 shares of our common stock.

Accrued liabilities increased from \$6,357,000 as at December 31, 2005 to \$7,103,000 at September 30, 2006 due primarily to an increase in accrued professional fees and loan interest at the end of the period. Approximately \$4,931,000 relates to the disputed Weatherford invoices referred to in Note 13 of these financial statements.

Long term debt net of discounts increased from \$25,000,000 at December 31, 2005 to \$53,000,000 less discounts of \$13,882,000 due to the issuance of the \$13,000,000 in Senior Subordinated Notes in March 2006, the \$10,000,000 issue of the 12% Notes in June 2006 and the issue of the \$5,000,000 Senior Secured Notes by our wholly owned subsidiary, Tethys, in September 2006 which have been reduced by unamortized debt discounts associated with the detachable warrants and beneficial conversion features of the Notes in the amount of \$13,882,000. The long-term debt at December 31, 2005 of \$25,000,000 relates to the issue of the \$25,000,000 in Senior Secured Notes in July 2005.

Other non current liabilities increased to \$1,848,000 at September 30, 2006 from \$1,001,000 at December 31, 2005 as a result of the difference in computing interest using the actual interest rate and the effective interest rate due on the \$25,000,000 in Senior Secured Notes, on the issue of \$13,000,000 in Senior Subordinated Notes, in March 2006 and also on the issue of the \$5,000,000 Senior Secured Notes by our wholly owned subsidiary, Tethys, in September 2006.

Provision for future site restoration increased to \$590,000 at September 30, 2006 from \$253,000 at December 31, 2005 primarily due to increases in the provisions for future site restoration in our Kazakhstan oil and gas properties.

Options with redemption feature increased from \$2,120,000 at December 31, 2005 to \$3,899,000 at September 30, 2006 due to an increase in the Company's share price over the period and an increase in the number of options vested in the period.

**Contractual Obligations and Commercial Terms**

Our principal business and assets are derived from production sharing contracts and agreements ( PSCs ) in Georgia and to a lesser extent, in Kazakhstan. The legislative and procedural regimes governing PSCs and mineral use licenses in Georgia have undergone a series of changes in recent years resulting in certain legal uncertainties.

Our PSCs and mineral use licenses, entered into prior to the introduction in 1999 of a new Petroleum Law governing such agreements have not, as yet, been amended to reflect or ensure compliance with current legislation. As a result, despite references in the current legislation grandfathering the terms and conditions of our PSCs, conflicts between the interpretation of our PSCs and mineral use licenses and current legislation could arise. Such conflicts, if they arose, could cause an adverse effect on our rights under the PSCs. However the Norio PSA and the Tbilisi PSC were concluded after enactment of the Petroleum Law, and under the terms and conditions of this legislation.

To confirm that the Ninotsminda Production Sharing Contract (the Ninotsminda PSC ) and the mineral usage license issued prior to the introduction in 1999 of the Petroleum Law were validly issued, in connection with its preparation of the Convertible Loan Agreement with us, the International Finance Corporation, an affiliate of the World Bank received in November 1998 confirmation from the State of Georgia, that among other things:

The State of Georgia recognizes and confirms the validity and enforceability of the Ninotsminda PSC and the license and all undertakings the State has covenanted with Ninotsminda Oil Company Limited ( NOC ) thereunder; the license was duly authorized and executed by the State at the time of its issuance and remained in full force and effect throughout its term; and

the license constitutes a valid and duly authorized grant by the State, being and remaining in full force and effect as of the signing of this confirmation and the benefits of the license fully extend to

**Table of Contents**

NOC by virtue of its interest in the license holder and the contractual rights under the Ninotsminda PSC.

Despite this confirmation and the grandfathering of the terms of existing PSCs in the Petroleum Law, subsequent legislative or other governmental changes could conflict with, challenge our rights or otherwise change current operations under the Ninotsminda PSC. No challenge has been made to date.

We have contingent obligations and may incur additional obligations, absolute and contingent, with respect to the acquisition and development of oil and gas properties and ventures in which we have interests that require or may require us to expend funds and to issue shares of our Common Stock.

At September 30, 2006, we had the contingent obligation to issue an aggregate of 187,500 shares of our Common Stock to Fielden Management Services PTY, Ltd (a third party management services company), subject to the satisfaction of conditions related to the achievement of specified performance standards by the Stynawske Field project, an oil field in Ukraine in which we had a previous interest.

On June 28, 2006, the Company entered into a Conversion Agreement with the holders of the Senior Subordinated Notes. As an inducement for the note holders to convert the Senior Subordinated Notes into Tethys common stock, the Company agreed to issue the Note holders 13,000,000 warrants ( Compensation Warrants ) to purchase CanArgo common stock at an exercise price of \$1.00 per common share. The Company will recognize the fair market value of the Compensation Warrants as of the date of the Conversion Agreement as an expense at the time of the conversion of the Senior Subordinated Notes. Had the Conversion Agreement been effective as of September 30, 2006, the Company would have recorded compensation from the Compensation Warrants of \$3,827,200 based on a valuation using the Black-Scholes model.

Under the Production Sharing Contract for Blocks XI<sup>G</sup> and XI<sup>H</sup> (the Tbilisi PSC ) in Georgia our subsidiary CanArgo Norio Limited had a commitment to acquire additional seismic data within three years of the effective date of the contract which is September 29, 2003. The State Agency for Oil & Gas Regulation in Georgia has consented to an extension to the period within which the data should be acquired to the end of 2007 and we are currently working with the State Agency to amend the Tbilisi PSC accordingly. The total commitment over the remaining period is \$350,000.

In 2002, the Participation Agreement for the three well exploration program on the Ninotsminda /Manavi area with AES Gardabani (a subsidiary of AES Corporation) ( AES ) was terminated without AES earning any rights to any of the Ninotsminda / Manavi area reservoirs. We therefore have no present obligations in respect of AES. However, under a separate Letter of Agreement, if gas from the Sub Middle Eocene is discovered and produced from the exploration area covered by the Participation Agreement, AES will be entitled to recover at the rate of 15% of future gas sales from the Sub Middle Eocene, net of operating costs, approximately \$7,500,000, representing their prior funding under the Participation Agreement.

On February 4, 2005, NOC and PFG agreed to terminate the Sales Agreement and enter into a new agreement ( New Agreement ) whereby PFG would receive an immediate repayment of its Security Deposit and obtain an extended term over which it can purchase crude oil produced from the Ninotsminda Field while NOC receives better commercial terms for the sale of its production. The New Agreement has a minimum term of 45 months and contains the following principal terms:

- (1) NOC will make available to PFG NOC's entire share of production from the Ninotsminda Field including a minimum total amount of 68,555 metric tonnes (the Minimum Contract Quantity ). In the event NOC fails to produce the Minimum Contract Quantity it will have no liability to PFG;
- (2) The delivery point shall be at Georgian Oil's storage reservoirs at Samgori (adjacent to the Ninotsminda Field);
- (3) The price for the oil will be in US Dollars per net US Barrel equal to the average of the mean of three quotations in Platts Crude Oil Marketwire<sup>®</sup> for Brent Dated Quotations minus a discount: ranging for sales (a) up to the Minimum Contract Quantity from \$6.00 to \$7.50 based on Brent prices per barrel ranging from less than \$15.00 to greater than \$25.01, respectively; and (b) for sales of oil in excess of the Minimum Contract Quantity at the commercial discount in Georgia for oil of similar quality less \$0.10 per barrel with the



**Table of Contents**

maximum discount being \$6.00 per barrel for export sales and \$5.50 per barrel for local sales; and  
 (4) PFG will pay NOC for the monthly quantity of oil in advance of delivery.

NOC's obligations are subject to customary Force Majeure provisions, title and risk of loss pass to buyer at the delivery point, NOC agrees to assist the buyer to sell the oil locally or export oil in accordance with applicable law and the new Agreement is governed by English law.

The last two oil sales concluded by NOC were to third party buyers as PFG was not able to comply with the terms of the New Agreement.

In September 2004, a blow-out occurred at the N100 well on the Ninotsminda Field. The Company currently estimates that the total costs attributable to the blow-out, including compensation and cleaning of the environment will be \$2,000,000. The Company's insurance policies cover 80% of these costs up to a maximum of \$2,500,000 and the remaining 20% insurance retention being payable by the Company. On June 3, 2005 we received \$800,000, as a first instalment, from our insurance company.

On July 27, 2005, GBOC Ninotsminda, an indirect subsidiary of the Company, received a claim raised by certain of the Ninotsminda villagers (listed on pages 1 to 76 of the claim) in the Tbilisi Regional Court in respect of damage caused by the blowout of the N100 well on the Ninotsminda Field in Georgia on September 11, 2004. An additional claim was received in December 2005 thus bringing the relief sought pursuant to both claims to the sum of 32.4 million GEL (approximately \$18.7 million at the exchange rate of GEL to US dollars in effect on September 30, 2006). At a hearing in March 2006 the plaintiffs increased the amount of damages sought to 50,000 GEL (approximately \$29,000) per plaintiff, which increased the total claim to approximately \$182,000,000. We believe that we have meritorious defences to this claim and intend to defend it vigorously.

On September 12, 2005, WEUS Holding Inc ( WEUS ) a subsidiary of Weatherford International Ltd lodged a formal Request for Arbitration with the London Court of International Arbitration against CanArgo Energy Corporation in respect of unpaid invoices for work performed under the Master Service Contract dated June 1, 2004 between the Company and WEUS for the supply of under-balanced coil tubing drilling equipment and services during the first and second quarter of 2005. Pursuant to the Request for Arbitration, WEUS' demand for relief is \$4,931,332.55. Although the Company has recorded all amounts billed by WEUS as of December 31, 2005 (see Note 13) the Company is contesting the claim and has filed a counterclaim. We believe that we have meritorious defences to this claim and intend to defend it vigorously.

Under the Ninotsminda PSC, Ninotsminda Oil Company Ltd is required to relinquish at least half of the area then covered by the production sharing contract, but not in portions being actively developed, at five year intervals commencing December 1999. In 1998, these terms were amended with the initial relinquishment being due in 2008 and a reduction in the area to be relinquished at each interval from 50% to 25% whereby the Contractor selects the relinquishment portions.

The Norio (Block XI C ) and North Kumisi Production Sharing Agreement ( Norio PSA ) in which CanArgo Norio Limited currently owns a 100% interest, although this interest may be reduced to 85% should the state oil company, Georgian Oil, exercise an option available to it under the PSA for a limited period following the submission of a field development plan. As a contractor party, Georgian Oil would be liable for all costs and expenses in relation to any interest it may acquire in the PSA. This PSA covers an area of approximately 285,777 acres (1,179 km<sup>2</sup>).

Our 2004 Long-Term Stock Incentive Plan, as amended, ( 2004 Plan ) allows for up to 17,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. Stock options may be exercised, in whole or in part, by giving written notice of exercise to the Company specifying the number of shares to be purchased. However, in the event of a Change of Control (as defined in the 2004 Plan) an optionee (other than an optionee who initiated a Change of Control in a capacity other than as an officer or director of the Company) may elect to surrender all or part of the stock option to the Company and to receive in cash an amount equal to the amount by which the fair market value per share of the Stock on the date of exercise shall exceed the purchase price per share under the stock option multiplied by the number of shares of the Stock granted under the stock option as to which the right granted by this proviso shall have been exercised. As of September 30, 2006,



**Table of Contents**

options to acquire an aggregate of 7,642,000 shares of common stock had been granted under this Plan and were outstanding, 6,379,000 of which are currently vested.

At September 30, 2006 our Kazakhstan subsidiary, BN Munai LLP, had entered into contracts with Tip-Top International Development Limited and RemSpetsTekhKran LLP totalling approximately \$9,000,000 for the purchase and construction of pipeline, infield lines and compressors for the delivery of gas into the main Bukhara Urals gas trunkline. Payments of approximately \$4,426,000 have been made to September 30, 2006 in connection with these contracts.

**Lease Commitments** We lease office space under non-cancellable operating lease agreements.

**Results of Continuing Operations***Nine Month Period Ended September 30, 2006 Compared to Nine Month Period Ended September 30, 2005*

We recorded operating revenue from continuing operations of \$4,092,000 during the nine month period ended September 30, 2006 compared with \$3,931,000 for the nine month period ended September 30, 2005. The increase is attributable mainly to a higher price per barrel realized by the Company in 2006 offset partially by lower sales volumes achieved from the Ninotsminda Field in 2006. Ninotsminda Oil Company Limited ( NOC ) sold 69,287 barrels of oil for the nine month period ended September 30, 2006 compared to 89,378 barrels of oil for NOC for the nine month period ended September 30, 2005.

NOC generated \$4,092,000 of oil and gas revenue in the nine month period ended September 30, 2006 compared with \$3,931,000 for the nine month period ended September 30, 2005 primarily due to a higher average net sales price offset partially by lower sales volumes. Its net share of the 134,593 (493 barrels per day) of gross oil production for sale from the Ninotsminda Field in the period amounted to 87,485 barrels. In the period, 18,198 barrels of oil were added to storage. For the nine month period ended September 30, 2005, NOC's net share of the 138,319 (507 barrels per day) of gross oil production was 89,907 barrels.

NOC's entire share of production was either sold locally in Georgia under both national and international contracts or added to storage. Net sale prices for Ninotsminda oil sold during the first nine months of 2006 averaged \$55.47 per barrel as compared with an average of \$44.17 per barrel in the first nine months of 2005. NOC's net share of the 570,179 thousand cubic feet (mcf) of gas delivered was 370,617 mcf at an average net sale price of \$0.62 per mcf of gas for the nine month period ended September 30, 2006. For the nine month period ended September 30, 2005, NOC's net share of the 89,300 thousand cubic feet (mcf) of gas delivered was 46,307 mcf at an average net sale price of \$0.53 per mcf of gas.

The operating loss from continuing operations for the nine month period ended September 30, 2006 amounted to \$10,461,000 compared with an operating loss of \$7,561,000 for the nine month period ended September 30, 2005. The increase in operating loss is attributable to increased field operating expenses, increased selling, general and administration costs, increased depreciation, depletion and amortization, partially offset by increased oil and gas revenue and reduced direct project costs.

Field operating expenses increased to \$1,340,000 for the nine month period ended September 30, 2006 as compared to \$1,328,000 for the nine month period ended September 30, 2005. The increase is primarily a result of increased oil processing fees in the period.

Direct project costs decreased to \$678,000 for the nine month period ended September 30, 2006, from \$910,000 for the nine month period ended September 30, 2005 primarily due to reduced costs directly associated with non operating activity at the Ninotsminda Field.

Selling, general and administrative costs increased to \$10,284,000 for the nine month period ended September 30, 2006 from \$7,453,000 for the nine month period ended September 30, 2005. The increase is a result of consolidating our Kazakhstan related subsidiaries, professional fees incurred in relation to the proposed Tethys Spin Out, increased non cash stock compensation expense and a general increase in corporate activity.

The increase in depreciation, depletion and amortization expense to \$2,252,000 for the nine month period ended September 30, 2006 from \$1,801,000 for the nine month period ended September 30, 2005 is attributable principally to increased production for the nine month period ended September 30, 2006 compared to the nine month period ended September 30, 2005.



**Table of Contents**

The increase in other expense to \$4,185,000 for the nine month period ended September 30, 2006, from \$555,000 for the nine month period ended September 30, 2005 is primarily a result of higher loan interest payable and amortised debt discount and also increased levels of bad debts partially offset by foreign exchange gains and higher interest income as a result placing surplus cash on term deposits until needed.

The loss from continuing operations of \$14,646,000 or \$0.07 per share for the nine month period ended September 30, 2006 compares to a net loss from continuing operations of \$8,117,000 or \$0.04 per share for the nine month period ended September 30, 2005.

The weighted average number of common shares outstanding was higher during the nine month period ended September 30, 2006 than during the nine month period ended September 30, 2005, principally due to the issue of shares under the terms of the SEDA in 2005 to repay the Cornell Capital promissory notes and in connection with additional takedowns under the SEDA, the exercise of share options in 2005 and 2006, the issue of shares in respect of the Tethys buyout and the issue of shares in respect of the forced conversion of a convertible Loan with Detachable Warrants in 2006.

*Three Month Period Ended September 30, 2006 Compared to Three Month Period Ended September 30, 2005*

We recorded operating revenue from continuing operations of \$2,090,000 during the three month period ended September 30, 2006 compared with \$2,581,000 for the three month period ended September 30, 2005. This decrease is primarily attributable to lower sales volumes achieved from the Ninotsminda Field in 2006 partially offset by a higher price per barrel realized by the Company in 2006. Ninotsminda Oil Company Limited ( NOC ) sold 38,968 barrels of oil for the three month period ended September 30, 2006 compared to 51,507 barrels of oil for the three month period ended September 30, 2005.

NOC generated \$2,090,000 of oil and gas revenue in the three month period ended September 30, 2006 compared with \$2,581,000 for the three month period ended September 30, 2005 primarily due to lower sales volumes achieved from the Ninotsminda Field in 2006 partially offset by a higher price per barrel realized by the Company in 2006. For the three month period ended September 30, 2006, its net share of the 40,798 (443 barrels per day) of gross oil production for sale from the Ninotsminda Field in the period amounted to 26,519 barrels. In the period, 12,449 barrels of oil were sold from storage. For the three month period ended September 30, 2005, NOC's net share of the 43,292 barrels (471 barrels per day) of gross oil production was 28,140 barrels.

NOC's entire share of production was either sold locally in Georgia under both national and international contracts or added to storage. Net sale prices for Ninotsminda oil sold during the third quarter of 2006 averaged \$52.67 per barrel as compared with an average of \$50.11 per barrel in the third quarter of 2005. Its net share of the 57,998 thousand cubic feet (mcf) of gas delivered was 37,698 mcf at an average net sale price of \$0.46 per mcf of gas. No gas sales were delivered for the three month period ended September 30, 2005.

The operating loss from continuing operations for the three month period ended September 30, 2006 amounted to \$3,492,000 compared with an operating loss of \$2,527,000 for the three month period ended September 30, 2005. The increase in operating loss is attributable to increased selling, general and administration costs partially offset by reduced oil and gas revenue, lower field operating expenses, direct project costs and depreciation, depletion and amortization in the period.

Field operating expenses decreased to \$446,000 for the three month period ended September 30, 2006 as compared to \$756,000 for the three month period ended September 30, 2005. The decrease is primarily a result of higher costs deferred to inventory as at the end of September 30, 2006 compared to the corresponding period in 2005.

Direct project costs decreased to \$235,000 for the three month period ended September 30, 2006, from \$304,000 for the three month period ended September 30, 2005, primarily due to reduced costs directly associated with non operating activity at the Ninotsminda Field.

Selling, general and administrative costs increased to \$4,181,000 for the three month period ended September 30, 2006 from \$3,278,000 for the three month period ended September 30, 2005. The increase is a result of consolidating the results of our Kazakhstan related subsidiaries, professional fees

**Table of Contents**

incurred in relation to the proposed Tethys Spin Out, increased non cash stock compensation expense and a general increase in corporate activity.

The decrease in depreciation, depletion and amortization expense to \$721,000 for the three month period ended September 30, 2006 from \$770,000 for the three month period ended September 30, 2005 is attributable principally to decreased production for the three month period ended September 30, 2006 compared to the three month period ended September 30, 2005.

The increase in other expense to \$2,208,000 for the three month period ended September 30, 2006, from \$275,000 for the three month period ended September 30, 2005 is primarily a result of higher loan interest payable, amortised debt discount, increased levels of bad debts partially offset by foreign exchange gains and higher interest income as a result of placing surplus cash on term deposits until needed.

The loss from continuing operations of \$5,700,000 or \$0.03 per share for the three month period ended September 30, 2006 compares to a net loss from continuing operations of \$2,802,000 or \$0.01 per share for the three month period ended September 30, 2005.

The weighted average number of common shares outstanding was higher during the three month period ended September 30, 2006 than during the three month period ended September 30, 2005, principally due to the exercise of share options in 2006, the issue of shares in respect of the Tethys Petroleum Investments Limited buyout and the issue of shares in respect of the forced conversion of a convertible Loan with Detachable Warrants in 2006.

**Results of Discontinued Operations***Nine Month Period Ended September 30, 2006 Compared to Nine Month Period Ended September 30, 2005*

On February 17, 2006 we issued a press release announcing that our subsidiary, CSL, was not proceeding with further investment in Samgori (Block XI<sup>B</sup>) Production Sharing Contract ( Samgori PSC ) in Georgia and associated farm-in which became effective in April 2004, and accordingly we terminated our 50% interest in the Samgori PSC with effect from February 16, 2006.

The net income from discontinued operations, net of taxes and minority interest for the nine month period ended September 30, 2006 of \$763,000 increased from \$445,000 for the nine month period ended September 30, 2005 due to the activities of CSL. On February 16, 2006 we withdrew from the Samgori PSC.

CSL generated \$1,003,000 of oil and gas revenue in the nine month period ended September 30, 2006 compared with \$1,216,000 for the nine month period ended September 30, 2005 primarily due to a higher average net sales price achieved in the nine month period ended September 30, 2006 offset by lower sales volumes. Its net share of the 10,226 (218 barrels per day) of gross oil production for sale from the Samgori Field in the period up to February 16, 2006, the date of withdrawal, amounted to 3,835 barrels. In the period, 5,141 barrels of oil were added to storage. For the nine month period ended September 30, 2005, CSL's net share of the 127,122 barrels (695 barrels per day) of gross oil production was 46,671 barrels.

CSL's entire share of production was either sold locally in Georgia under international contracts or added to storage. Net sale prices for CSL oil sold during the first nine months of 2006 averaged \$59.57 per barrel as compared with an average of \$42.58 per barrel in the first nine months of 2005.

*Three Month Period Ended September 30, 2006 Compared to Three Month Period Ended September 30, 2005*

The net loss from discontinued operations, net of taxes and minority interest for the three month period ended September 30, 2006 of \$18,000 compares to a net loss from discontinued operations of

**Table of Contents**

\$140,000 for the three month period ended September 30, 2005 due to the activities of CanArgo Samgori Limited ( CSL ). On February 16, 2006 we withdrew from the Samgori PSC.

CSL generated \$0 of oil and gas revenue in the three month period ended September 30, 2006 compared with \$0 for the three month period ended September 30, 2005.

**Commitments and Contingencies**

See Item 1, Financial Statements, Note 16, which is incorporated herein by reference.

**Forward-Looking Statements**

The forward-looking statements contained in this Item 2 and elsewhere in this Form 10-Q are subject to various risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated in such forward-looking statements. Included among the important risks, uncertainties and other factors are those hereinafter discussed.

Operating entities in various foreign jurisdictions must be registered by governmental agencies, and production licenses for development of oil and gas fields in various foreign jurisdictions must be granted by governmental agencies. These governmental agencies generally have broad discretion in determining whether to take or approve various actions and matters. In addition, the policies and practices of governmental agencies may be affected or altered by political, economic and other events occurring either within their own countries or in a broader international context.

We may not have a majority of the equity that is the licence developer of some projects that we may pursue in countries that were a part of the former Soviet Union, even though we may be the designated operator of the oil or gas field. In such circumstances, the concurrence of co-venturers may be required for various actions. Other parties influencing the timing of events may have priorities that differ from ours, even if they generally share our objectives. Demands by or expectations of governments, co-venturers, customers and others may affect our strategy regarding the various projects. Failure to meet such demands or expectations could adversely affect our participation in such projects or our ability to obtain or maintain necessary licenses and other approvals.

Our ability to finance all of our present oil and gas projects and other ventures according to present plans is dependent upon obtaining additional funding. An inability to obtain financing could require us to scale back or abandon part or all of our project development, capital expenditure, production and other plans. The availability of equity or debt financing to us or to the entities that are developing projects in which we have interests is affected by many factors, including:

world economic conditions;

the state of international relations;

the stability and policies of various governments located in areas in which we currently operate or intend to operate;

fluctuations in the price of oil and gas, the outlook for the oil and gas industry and competition for available funds; and

an evaluation of us and specific projects in which we have an interest.

Rising interest rates might affect the feasibility of debt financing that is offered. Potential investors and lenders will be influenced by their evaluations of us and our projects and comparisons with alternative investment opportunities.

The development of oil and gas properties is subject to substantial risks. Expectations regarding production, even if estimated by independent petroleum engineers, may prove to be unrealized. There are many uncertainties in estimating production quantities and in projecting future production rates and the timing and amount of future development expenditures. Estimates of properties in full production are more reliable than production estimates for new discoveries and other properties that are not fully productive. Accordingly, estimates related to our properties are subject to change as additional information becomes available.





## **Table of Contents**

Most of our interests in oil and gas properties and ventures are located in former Soviet Union countries. Operations in those countries are subject to certain additional risks including the following:

uncertainty as to the enforceability of contracts;

currency convertibility and transferability;

unexpected changes in fiscal and tax policies;

sudden or unexpected changes in demand for crude oil and or natural gas;

the lack of trained personnel; and

the lack of equipment and services and other factors that could significantly change the economics of production.

Production estimates are subject to revision as prices and costs change. Production, even if present, may not be recoverable in the amount and at the rate anticipated and may not be recoverable in commercial quantities or on an economically feasible basis. World and local prices for oil and gas can fluctuate significantly, and a reduction in the revenue realizable from the sale of production can affect the economic feasibility of an oil and gas project. World and local political, economic and other conditions could affect our ability to proceed with or to effectively operate projects in various foreign countries.

Demands by, or expectations of governments, co-venturers, customers and others may affect our strategy regarding the various projects. Failure to meet such demands or expectations could adversely affect our participation in such projects or our ability to obtain or maintain necessary licenses and other approvals.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our principal exposure to market risk is due to changes in oil and gas prices and currency fluctuations. As indicated elsewhere in this Report, as a producer of oil and gas we are exposed to changes in oil and gas prices as well as changes in supply and demand which could affect its revenues. We do not engage in any commodity hedging activities. Due to the ready market for our production in Georgia, we do not believe that any current exposures from this risk will materially affect our financial position at this time, but there can be no assurance that changes in such market will not affect CanArgo adversely in the future.

Also, as indicated elsewhere in this Report, because all of our operations are being conducted in countries that were a part of the former Soviet Union, we are potentially exposed to the market risk of fluctuations in the relative values of the currencies in areas in which we operates. At present we do not engage in any currency hedging operations since, to the extent we receive payments for our production in local currencies, we are utilizing such currencies to pay for our local operations. In addition, we frequently sell our production from the Ninotsminda Field in Georgia under export contracts which provide for payment in US dollars.

CanArgo had no material interest in investments subject to market risk during the period covered by this report.

Because the majority of all revenue to us is from the sale of production from the Ninotsminda Field a change in the price of oil or a change in the production rates could have a substantial effect on this revenue and therefore profits.

### **Item 4. Controls and Procedures**

#### ***Disclosure Control and Procedures***

We reported in our Form 10-K filed with the Securities and Exchange Commission on March 16, 2006 that we had identified material weaknesses in our *internal control over financial reporting* which are listed below.

As of the end of the period covered by this report, and under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of these disclosure controls and procedures.

**Table of Contents**

Based on this evaluation and based on the material weaknesses disclosed below our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of such date.

We have identified the following material weaknesses in internal control over financial reporting:

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected. We have concluded that our internal control over financial reporting was ineffective as of September 30, 2006 and that we have material weaknesses in each of the following areas:

1. Financial Statement Close Process

The Company's controls over the financial reporting close process were not consistently applied. As a result, the Company has a material weakness related to its ability to compile and review accurate financial statements.

The financial statement close process relies heavily upon manual rather than automated system process controls and places significant reliance on spreadsheets;

Formal policies and procedures in many functions including maintenance of the Chart of Accounts, financial statement close, purchasing, payroll, and cash management operations do not exist;

Preparation and review of account reconciliations, particularly in Georgia and Kazakhstan, are not performed; and

There is no review, reconciliation or approval of various schedules and reconciliations, including the transfer of amounts from subsidiary trial balances to consolidating spreadsheets prepared to support the financial close and disclosure processes

These material weaknesses related to the financial statement close process affect all of the Company's significant accounts and could result in a material misstatement to the Company's annual or interim consolidated financial statements that would not be prevented or detected.

2. Disclosure Controls

The Company's disclosure controls and procedures were not effective in providing reasonable assurance that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Inadequate controls include the lack of procedures used for identifying, determining and calculating required disclosures and other supplementary information requirements

3. Information Technology

The Company did not adequately implement certain controls over information technology, including certain spreadsheets, used in its core business and financial reporting. These areas included logical access security controls to financial applications, segregation of duties and backup and recovery procedures. The Company's controls over the completeness, accuracy, validity, restricted access, and the review of certain spreadsheets used in the period-end financial statement preparation and reporting process was not designed appropriately. This material weakness affects the Company's ability to prevent improper access and changes to its accounting records.

4. Production

The Company did not have effective controls and procedures to ensure that revenues and associated costs from the sales of its products based on production and transmission records between the

**Table of Contents**

Company and its third party production sharing partner were reconciled or correctly recognized. Controls associated with the product transmission are performed by the third party production sharing partner and there is no evidence that these controls have been reviewed by the Company.

Deficiencies in the Company's internal controls and procedures relating to the recording of production do not allow assurance that revenues and costs are recognized in accordance with generally accepted accounting principles.

**5. Inventory Management**

The Company did not maintain a control environment that fully emphasized the establishment of, adherence to, or adequate communication regarding appropriate internal control for the management of its inventory, including the lack of documented procedures to update and review the material master file and valuation table or compare the cost of inventory to net realizable value.

These weaknesses increased the likelihood of potential material errors in the Company's financial reporting.

**6. Entity Level Controls**

As evidenced by the material weaknesses described above, entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively. This includes a lack of adequate mechanisms for anticipating and identifying financial reporting risks and for reacting to changes in the operating environment that could have a potential effect on financial reporting. Such entity level controls, and a comprehensive monitoring of internal controls, are part of the framework to ensure that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed.

As a result, misappropriation of assets and misstatements in the financial statements could occur and not be prevented or detected by the Company's controls in a timely manner. In the light of the review Management, in consultation with the Audit Committee, is reviewing the most cost effective way to address the issues raised. Management considers that remediation measures will include the appointment of a Group Compliance Officer with responsibility for ensuring the preparation, review, testing and updating of the appropriate policies, procedures and standards.

As of September 30, 2006 the material weaknesses identified above had not been remediated.

**CEO and CFO Certifications** The Certifications of our CEO and CFO which are attached as Exhibits 31(1) and 31(2) to this Report include information about our disclosure controls and procedures and internal control over financial reporting.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control in the third quarter except for the employment of a Country Financial Controller in July 2006 in Kazakhstan to strengthen the financial close process at both Head Office and in Kazakhstan.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

On September 12, 2005, WEUS Holding Inc ( WEUS ) a subsidiary of Weatherford International Ltd lodged a formal Request for Arbitration with the London Court of International Arbitration against CanArgo Energy Corporation in respect of unpaid invoices for work performed under the Master Service Contract dated June 1, 2004 between the Company and WEUS for the supply of under-balanced coil tubing drilling equipment and services during the first and second quarter of 2005. Pursuant to the Request for Arbitration, WEUS demand for relief is \$4,931,332. The Company is contesting the claim and has filed a counterclaim.

On July 27, 2005, GBOC Ninotsminda, an indirect subsidiary of the Company, received a claim raised by certain of the Ninotsminda villagers (listed on pages 1 to 76 of the claim) in the Tbilisi Regional Court in respect of damage caused by the blowout of the N100 well on the Nintosminda Field in Georgia on September 11, 2004. An additional claim was received in December 2005 thus bringing the relief sought pursuant to both claims to the sum of 32.4 million GEL (approximately \$18.7 million at the exchange rate of GEL to US dollars in effect on September 30, 2006). At a hearing in March 2006 the plaintiffs increased the amount of damages sought to 50,000 GEL (approximately \$29,000) per plaintiff, which increased the total claim to approximately \$182,000,000.

The Company has been named in a legal action commenced in Alberta, Canada, with a group of defendants by former interest holders of the Lelyaki Oil Field in the Ukraine. The defendants are seeking damages of approximately 600,000 CDN (approx \$537,000 at September 30, 2006 exchange rates). The former owners of UK-Ran Oil Corporation disposed of their investment in the field prior to selling the Company to CanArgo. CanArgo believes the claim against it to be meritless. The Company is unable at this time to determine a potential outcome.

We believe that we have meritorious defences to all three claims and intend to defend them vigorously.

Other than the foregoing, as at September 30, 2006 there were no legal proceedings pending involving the Company, which, if adversely decided, would have a material adverse effect on our financial position or our business. From time to time we are subject to various legal proceedings in the ordinary course of our business.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On October 13, 2006, we announced the completion of a private placement in Norway of an aggregate of 12,263,368 shares of common stock at a purchase price of NOK 9.10 per share, for aggregate gross proceeds of NOK 111,596,239 (\$16,687,039 equivalent based upon a conversion rate of NOK 6.6876 per dollar) before placing fees and expenses estimated at NOK 6,695,774 (\$1,001,022). The shares were issued in a transaction intended to qualify for the exemption from registration afforded by Section 4(2) of the Securities Act and Regulation S promulgated thereunder. CanArgo agreed to register the Shares for resale under the Securities Act and the Company filed a Registration Statement on Form S-3 with the SEC on October 13, 2006, which included these shares. As at November 9, 2006 the Registration Statement on Form S-3 has not been declared effective. As a result of the delays incurred in registering the Shares we have paid subscribers a cash liquidity penalty of 5% of the subscription price of their Shares in the aggregate amount of NOK 5,579,812 (\$834,352 equivalent). The net proceeds of the placement will be used by the Company for working capital; future capital expenditures in Georgia, including, without limitation, securing drilling equipment; and other related activities.

**Table of Contents**

**Item 6. Exhibits**

**(a) Exhibits**

Management Contracts, Compensation Plans and Arrangements are identified by an asterisk (\*) Documents filed herewith are identified by a cross ( ).

- 1(1) Placement Agent Agreement dated September 22, 2004 by and between ABG Sundal Collier, Norge ASA and CanArgo Energy Corporation (Incorporated herein by reference from Amendment No 2 to Registration Statement on Form S-3 filed August 31, 2004 (Reg. No. 333-115645)).
- 1(2) Placement Agent Agreement dated September 22, 2004 by and between ABG Sundal Collier Inc. and CanArgo Energy Corporation (Incorporated herein by reference from Amendment No 1 to Registration Statement on Form S-3 filed July 1, 2004 (Reg. No. 333-115645)).
- 1(3) Engagement letter between ABG Sundal Collier Norge ASA and CanArgo Energy Corporation dated March 23, 2004 (Incorporated herein by reference from March 31, 2004 Form 10-Q).
- 1(4) Placement Agreement by and between the Company, Terra Securities ASA and Orion Securities ASA (Incorporated herein by reference from Registration Statement on Form S-3 filed October 13, 2006 (Reg. No. 333-137993)).
- 2(4) Memorandum of Agreement between Fielden Management Services Pty, Ltd., A.C.N. 005 506 123 and Fountain Oil Incorporated dated May 16, 1995 (Incorporated herein by reference from December 31, 1997 Form 10-K/A).
- 3(1) Registrant's Certificate of Incorporation and amendments thereto (Incorporated by reference from the Company's Proxy Statements filed May 10, 1999, May 9, 2000 and March 17, 2006, and Form 8-K filed July 24, 1998 and May 23, 2006 and March 31, 2004 Form 10-Q filed on May 17, 2004).
- 3(2) Registrant's Bylaws (Incorporated herein by reference from Post-Effective Amendment No. 1 to Form S-1 Registration Statement, File No. 333-72295 filed on July 29, 1999).
- \*4(1) Amended and Restated 1995 Long-Term Incentive Plan (Incorporated herein by reference from Post-Effective Amendment No. 1 to Form S-1 Registration Statement, File No. 333-72295 filed on July 29, 1999).
- \*4(2) Amended and Restated CanArgo Energy Inc. Stock Option Plan (Incorporated herein by reference from March 31, 1998 Form 10-Q).
- \*4(3) CanArgo Energy Corporation 2004 Long Term Incentive Plan, as amended (Incorporated herein by reference from Form 8-K dated May 19, 2004 and the Company's definitive Proxy Statement filed March 17, 2006).
- 4(4) Amended and Restated Loan and Warrant Agreement between CanArgo Energy Corporation and Salahi Ozturk dated August 27, 2004 (Incorporated herein by reference from Form 8-K dated August 27, 2004)

**Table of Contents**

- 4(5) Note Purchase Agreement dated July 25, 2005 among CanArgo Energy Corporation and Ingalls & Snyder Value Partners, L.P. together with the other Purchasers (Incorporated herein by reference from Form 8-K/A dated July 28, 2005).
- 4(6) Registration Rights Agreement dated July 25, 2005 among CanArgo Energy Corporation and Ingalls & Snyder Value Partners, L.P. together with the other Purchasers (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 4(7) Note and Warrant Purchase Agreement dated March 3, 2006 among CanArgo Energy Corporation and the Purchasers party thereto (Incorporated herein by reference from Form 8-K dated March 8, 2006).
- 4(8) Registration Rights Agreement dated March 3, 2006 among CanArgo Energy Corporation and the Purchasers party thereto (Incorporated herein by reference from Form 8-K dated March 8, 2006).
- 4(9) Note and Warrant Purchase Agreement dated June 28, 2006 among CanArgo Energy Corporation and the Purchaser party thereto (Incorporated herein by reference from Form 8-K dated June 28, 2006).
- 4(10) Registration Rights Agreement dated June 28, 2006 among CanArgo Energy Corporation and the Purchaser party thereto (Incorporated herein by reference from Form 8-K dated June 28, 2006).
- 4(11) Form of Subscription Agreement dated as of September 19, 2006 by and between CanArgo Energy Corporation and the Purchaser named therein. (Incorporated herein by reference from Form 8-K dated October 13, 2006).
- 10(1) Production Sharing Contract between (1) Georgia and (2) Georgian Oil and JKX Ninotsminda Ltd. dated February 12, 1996 (Incorporated herein by reference from Form S-1 Registration Statement, File No. 333-72295 filed on September 7, 1999).
- \*10(2) Management Services Agreement between CanArgo Energy Corporation and Vazon Energy Limited relating to the provisions of the services of Dr. David Robson dated June 29, 2000 (Incorporated herein by reference from March 31, 2000 Form 10-Q). As amended by Deed of Variation of Management Services Agreement between CanArgo Energy Corporation and Vazon Energy Limited dated May 2, 2003 (Incorporated herein by reference to Form 8-K dated May 13, 2003).
- 10(3) Tenancy Agreement between CanArgo Energy Corporation and Grosvenor West End Properties dated September 8, 2000 (Incorporated herein by reference from March 31, 2000 Form 10-Q).
- 10(4) Production Sharing Contract between (1) Georgia and (2) Georgian Oil and CanArgo Norio Limited dated December 12, 2000 (Incorporated herein by reference from December 31, 2000 Form 10-K).
- \*10(5) Service Agreement between CanArgo Energy Corporation and Vincent McDonnell dated December 1, 2000 (Incorporated herein by reference from December 31, 2001 Form 10-K).
- 10(6) Sale agreement of CanArgo Petroleum Products Limited between CanArgo Limited and Westrade Alliance LLC dated October 14, 2002. (Incorporated herein by reference from March 31, 2002 Form 10-Q)

**Table of Contents**

- 10(7) Stock Purchase Agreement dated September 24, 2003 regarding the sale of all of the issued and outstanding stock of Fountain Oil Boryslaw (Incorporated herein by reference from March 31, 2003 Form 10-Q)
- 10(8) Agreement between CanArgo Samgori Limited and Georgian Oil Samgori Limited dated January 8, 2004 (Incorporated herein by reference from Form S-3 filed May 6, 2003 (Reg. No. 333-115261)).
- 10(9) Agreement dated March 17, 2004 between CanArgo Acquisition Corporation and Stanhope Solutions Ltd for the sale of Lateral Vector Resources Ltd. (Incorporated herein by reference from Form 8-K dated May 19, 2004).
- 10(10) Master Service Contract dated June 1, 2004 between CanArgo Energy Corporation and WEUS Holding Inc. (Incorporated herein by reference from Form 8-K dated June 1, 2004).
- 10(11) Agreement between Ninotsminda Oil Company Limited and Saipem S.p.A. dated January 27, 2005 (Incorporated herein by reference from Form 8-K dated January 27, 2005).
- 10(12) Agreement between Ninotsminda Oil Company Limited and Primrose Financial Group dated February 4, 2005 (Incorporated herein by reference from Form 8-K dated February 4, 2005).
- 10(13) Subsidiary Guaranty dated July 25, 2005 by and among Ninotsminda Oil Company Limited, CanArgo (Nazvrevi) Limited, CanArgo Norio Limited, CanArgo Limited, CanArgo Samgori Limited, Tethys Petroleum Investments Limited and CanArgo Ltd for the benefit of the holders of the Senior Secured Notes (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(14) Security Agreement dated July 25, 2005 among Ingalls & Snyder Value Partners, L.P. together with the other Purchasers (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(15) Agreement dated July 25, 2005 among CanArgo Limited and Ingalls & Snyder Value Partners, L.P. together with the other Purchasers (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(16) Security Interest Agreement (Securities) dated July 25, 2005 among CanArgo Ltd, CanArgo Limited, Ingalls & Snyder LLC as Security Agent for the Secured Parties (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(17) Security Interest Agreement (Securities) dated July 25, 2005 among Tethys Petroleum Investments Limited, CanArgo Limited, Ingalls & Snyder LLC, as Security Agent for the Secured Parties and the Secured Parties (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(18) Security Interest Agreement (Bank Account) dated July 25, 2005 by and among CanArgo Energy Corporation, Ingalls & Snyder LLC, as Security Agent for the Secured Parties and the Secured Parties (Incorporated herein by reference from Form 8-K dated July 27, 2005).
- 10(19) Subordinated Subsidiary Guaranty dated March 3, 2006 by and among Ninotsminda Oil Company Limited, CanArgo (Nazvrevi) Limited, CanArgo Norio Limited, CanArgo

**Table of Contents**

Limited, Tethys Petroleum Investments Limited, Tethys Kazakhstan Limited and CanArgo Ltd for the benefit of the holders of the Subordinated Notes (Incorporated herein by reference from Form 8-K dated March 8, 2006).

- 10(20) Subordinated Subsidiary Guaranty dated June 28, 2006 by and among Ninotsminda Oil Company Limited, CanArgo (Nazvrevi) Limited, CanArgo Norio Limited, CanArgo Limited, Tethys Petroleum Investments Limited, Tethys Kazakhstan Limited and CanArgo Ltd for the benefit of the holders of the 12% Notes (Incorporated herein by reference from Form 8-K dated June 28, 2006).
- 10(21) Waiver, Consent and Amendment Agreement dated March 3, 2006 by and among CanArgo Energy Corporation and the Purchasers party thereto (Incorporated herein by reference from Form 8-K dated March 8, 2006).
- 10(22) Waiver, Consent and Amendment Agreement dated June 28, 2006 by and among CanArgo Energy Corporation and the Senior Secured Note holders party thereto.
- 10(23) Waiver, Consent and Amendment Agreement dated June 28, 2006 by and among CanArgo Energy Corporation and the Senior Subordinated Note holders party thereto.
- 10(24) Conversion Agreement dated June 28, 2006 by and among CanArgo Energy Corporation, the Subordinated Noteholders and Persistency (Incorporated herein by reference from Form 8-K dated June 28, 2006).
- 10(25) Gas Supply Contract between BN Munai LLP and Gaz Impex S.A. LLP dated January 5, 2006 (Incorporated herein by reference from Form 8-K dated January 5, 2006)
- 10(26) Memorandum of Understanding dated as of March 2, 2006 by and between the Ministry of Energy of Georgia and CanArgo Energy Corporation (Incorporated herein by reference from Form 8-K dated March 8, 2006)
- \*10(27) Form of Management Service Agreement for Elizabeth Landles, Executive Vice President and Corporate Secretary dated February 18, 2004 (Incorporated herein by reference from Form 10-K dated March 16, 2006)
- \*10(28) Service Contract between CanArgo Energy Corporation and Jeffrey Wilkins dated August 22, 2006.
- 14 Code of Ethics (Incorporated herein by reference from December 31, 2004 Form 10-K).
- 21 List of Subsidiaries (Incorporated herein by reference from June 30, 2005 Form 10-Q)
- 31(1) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer of CanArgo Energy Corporation.
- 31(2) Rule 13a-14(c)/15d-14(a) Certification of Chief Financial Officer of CanArgo Energy Corporation.
- 32 Section 1350 Certifications.



**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**CANARGO ENERGY CORPORATION**

Date: November 9, 2006

By: /s/ Jeffrey Wilkins

Jeffrey Wilkins  
Chief Financial Officer  
54