ZARGON OIL & GAS LTD.

2017 Q1 FINANCIAL REPORT

FINANCIAL AND OPERATING HIGHLIGHTS

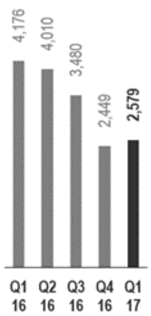
(unaudited)	Three Months Ended March 31, 2017	2016	Percent Change
Financial			
Income and Investments ($ millions)			
Petroleum and natural gas sales	**9.69**	9.61	1
Funds flow from/(used in) operating activities	**1.50**	(0.40)	475
Cash flows from operating activities	**(1.57)**	2.07	(176)
Net loss	**(0.54)**	(8.82)	94
Net capital expenditures	**2.51**	2.47	2
Per Share, Basic			
Funds flow from/(used in) operating activities ($/share)	**0.05**	(0.01)	600
Cash flows from operating activities ($/share)	**(0.05)**	0.07	(171)
Net loss ($/share)	**(0.02)**	(0.29)	93
Balance Sheet at Period End ($ millions)			
Property, plant and equipment	**136.09**	225.28	(40)
Exploration and evaluation assets	**2.30**	5.66	(59)
Bank debt	**–**	64.59	(100)
Convertible debentures at maturity	**41.94**	57.50	(27)
Net debt	**35.09**	124.37	(72)
Shareholders' equity	**33.70**	43.28	(22)
Total Common Shares Outstanding at Period End (millions)	**30.72**	30.47	1
Operating			
Average Daily Production			
Oil and liquids (bbl/d)	**2,016**	3,503	(42)
Natural gas (mmcf/d)	**3.38**	4.04	(16)
Equivalent (boe/d)	**2,579**	4,176	(38)
Average Selling Price (before the impact of financial risk management contracts)			
Oil and liquids ($/bbl)	**49.30**	28.27	74
Natural gas ($/mcf)	**2.45**	1.64	49
Undeveloped Land at Period End (thousand net acres)	**40**	71	(44)

Throughout this report, the calculation of barrels of oil equivalent ("boe") is based on the conversion ratio that six thousand cubic feet of natural gas is equivalent to one barrel of oil. For a further discussion about this term, refer to the Management's Discussion and Analysis section in this report.

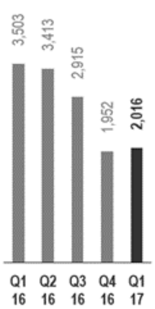
Funds flow from operating activities is an additional GAAP term that represents net earnings/(loss) except for non-cash items. Funds flow from operating activities have been restated to exclude asset retirement expenditures. For a further discussion about this term, refer to the Management's Discussion and Analysis section in this report.

Net debt is a non-GAAP measure that represents bank debt (if any) plus the convertible debenture of $41.94 million (as at March 31, 2017) or $57.50 million (prior to March 31, 2017) and any working capital excluding unrealized assets/liabilities.

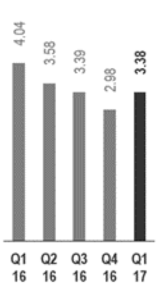
Production
(boe/d)



Oil and Liquids Production
(bbl/d)



Natural Gas Production
(mmcf/d)



Message to Shareholders (1) (2)

Zargon Oil & Gas Ltd. has released financial and operating results for the first quarter of 2017. Specific financial and operating highlights in the first quarter of 2017 include:

- Funds flow from operating activities of $1.50 million compare to $0.92 million recorded in the prior quarter, and the negative $0.40 million reported in first quarter of 2016. The year over year increase in funds flow is primarily due to Zargon's sharply higher first quarter 2017 field oil price of $49.30 per barrel, up 74 percent from the first quarter 2016 field oil price of $28.27 per barrel.
- First quarter 2017 production averaged 2,579 barrels of oil equivalent per day, a five percent increase from the preceding quarter rate of 2,449 barrels of oil equivalent per day, and a 38 percent decrease from the 2016 first quarter rate of 4,176 barrels of oil equivalent per day that had included our Southeast Saskatchewan and selected Alberta assets that were sold in the third quarter of 2016. During the 2017 first quarter, oil and liquids production represented 78 percent of Zargon's total production based on a 6:1 equivalent basis.
- First quarter 2017 field operating netbacks defined as sales (excluding hedges) less royalties and operating/transportation costs were $15.44 per barrel of oil equivalent up four percent from the fourth quarter 2016 field operating netback of $14.84 per barrel of oil equivalent. The corresponding first quarter 2017 field operating cash flow was $3.58 million, a seven percent gain from the prior quarter's $3.34 million.
- For the 2017 first quarter, field revenues (unhedged) were $41.74 per barrel of oil equivalent per day ($41.01 per barrel of equivalent per day in Q4 2016), royalties were $4.29 per barrel of oil equivalent per day ($4.54 per barrel of equivalent per day in Q4 2016) and operating (including transportation) costs were $22.01 per barrel of oil equivalent per day ($21.63 per barrel of equivalent per day in Q4 2016). The operating costs were higher than budget due to higher workover and winter related surface access costs than anticipated. We are continuing to budget operating costs of $20.96 per barrel of oil equivalent for the remainder of the year.
- First quarter 2017 capital expenditures were $2.51 million and were primarily allocated to oil exploitation costs relating to recompletions, reactivations and waterflood/ASP optimizations. These first quarter expenditures included $0.89 million of Little Bow ASP project costs ($0.35 million exploitation and $0.54 million chemical costs). No wells were drilled in the quarter.
- For the remainder of 2017, Zargon is budgeting $5.29 million of capital expenditures that is anticipated to completely offset the impact of Zargon's base production decline rate of less than 10 percent per year. The capital program will be focused on Little Bow non-ASP waterflood modifications and reactivations, Bellshill Lake pumping oil well optimizations, a Highvale Glauconite gas recompletion, Little Bow ASP project polymer costs and North Dakota Frobisher (Bluell) recompletions. The remaining 2017 capital program does not include the drilling of any of the 11 undeveloped oil exploitation wells recognized in our McDaniel 2016 year end reserve report, or the recommencement of Little Bow alkaline and surfactant injections. These growth capital expenditures will require additional funding, pursuant to our strategic alternatives initiative.
- First quarter 2017 abandonment and reclamation costs totaled $0.14 million and are forecast to total $1.50 million in 2017.
- On February 14, 2017, Zargon received the approval of amendments to the convertible debentures which extended the maturity date to December 31, 2019 from June 30, 2017, increased the interest rate to eight percent from six percent, and reduced the conversion price on conversion of the debentures to $1.25 from $18.80 per share. Zargon redeemed $15.56 million face value of debentures for $14.84 million of cash on March 31, 2017, leaving a remaining $41.94 million of convertible debentures outstanding. As of March 31, 2017, Zargon had no bank debt and positive

working capital (excluding the impact of unrealized derivatives) of $6.85 million, which resulted in net debt of $35.09 million.

- Zargon has entered into a significant oil hedging program to improve the stability and predictability to cash flows. Zargon's WTI hedges total 1,300 barrels of oil per day at a price of $69.24 Canadian for the period from April to December 2017. Additionally, Zargon has entered into a hedge to fix the differential between WTI and WCS (Western Canadian Select) prices at $19.50 Canadian for 1,300 barrels of oil per day for the period from April to December, 2017.
- On March 24, 2017, Zargon granted an aggregate of 1.34 million stock options to our directors, officers and certain employees at an exercise price of $0.72 per share, under a proposed plan that will be voted upon at our May 30, 2017 Annual and Special General Meeting.

Production Guidance (1)

In a December 12, 2016 capital budget press release, Zargon provided 2017 guidance levels of 2,500 barrels of oil equivalent per day. Actual first quarter volumes of 2,579 barrels of oil equivalent per day exceeded guidance levels by three percent, and guidance levels are maintained at 2,500 barrels of oil equivalent per day for the remainder of the year. These guidance levels are predicated on our $7.80 million 2017 capital program, of which $2.51 million was spent in the 2017 first quarter.

Strategic Alternatives Process Update (1)

In 2015, Zargon announced the formation of a Special Board Committee (the “Committee”) to examine alternatives that would maximize shareholder value in a manner that would recognize the Company's fundamental inherent value related to Zargon's long-life, low-decline conventional oil assets and the significant long term oil potential related to the Little Bow ASP project.

Last year’s $92.04 million of property sales and this year’s partial repayment and amendment of Zargon’s convertible debentures were a partial outcome of this process. With the debenture restructuring and elimination of bank debt now completed, the strategic alternatives process is continuing and may include a sale of the Company or a portion of the Company’s assets, a restructuring of the Company’s current capital structure, the addition of capital to further develop the potential of the assets, a merger, a farm-in or joint venture, or other such options as may be determined by the Company’s Board of Directors to be in the best interests of the Company and its stakeholders. Zargon’s Special Board Committee has engaged Macquarie Capital Markets Canada Ltd. (“Macquarie”) as its exclusive financial advisor related to this component of its strategic alternatives process. The Company has not set a definitive schedule to complete its evaluation and no decision on any particular alternative has been reached at this time. Zargon does not intend to disclose developments with respect to this process unless and until the Board of Directors has approved a definitive transaction or other course of action or otherwise deems disclosure of developments is appropriate or otherwise required by law. There are no guarantees that the process will result in a transaction of any form or, if a transaction is entered into, as to its terms or timing.

(1) Please see comments on “Forward-Looking Statements” in the Management’s Discussion and Analysis section in this report.

(2) Funds flow from operating activities have been restated to exclude asset retirement expenditures.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s 2017 first quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three months ended March 31, 2017 and the audited consolidated financial statements and related notes for the year ended December 31, 2016. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), which are also generally accepted accounting principles ("GAAP") for publicly accountable enterprises in Canada. All amounts are in Canadian dollars unless otherwise noted. All references to "Zargon" or the "Company" refer to Zargon Oil & Gas Ltd.

In the MD&A, natural gas is converted to a barrel of oil equivalent ("Boe") using six thousand cubic feet of gas to one barrel of oil. In certain circumstances, natural gas liquid volumes have been converted to a thousand cubic feet equivalent ("Mcfe") on the basis of one barrel of natural gas liquids to six thousand cubic feet of gas. Boes and Mcfes may be misleading, particularly if used in isolation. A conversion ratio of one barrel to six thousand cubic feet of natural gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Given that the value ratio based on the current price of crude oil as compared to natural gas is significantly different from the energy equivalency of 6:1, utilizing a conversion ratio on a 6:1 basis may be misleading as an indication of value.

The following are descriptions of additional GAAP measures used in this MD&A:

- *The MD&A contains the term "funds flow from operating activities" ("funds flow"), which should not be considered an alternative to, or more meaningful than, "cash flows from operating activities" as determined in accordance with IFRS as an indicator of the Company's financial performance. This term does not have any standardized meaning as prescribed by IFRS and, therefore, the Company's determination of funds flow from operating activities may not be comparable to that reported by other companies. The Company evaluates its performance based on net earnings and funds flow from operating activities. The Company considers funds flow from operating activities to be a key measure as it demonstrates the Company's ability to generate the cash necessary to repay debt and to fund future capital investment. It is also used by research analysts to value and compare oil and gas companies, and it is frequently included in published research when providing investment recommendations.*

The following are descriptions of non-GAAP measures used in this MD&A:

- *The Company uses the term "debt net of working capital" or "net debt". Debt net of working capital, as presented, does not have any standardized meaning prescribed by IFRS and may not be comparable with the calculation of similar measures for other entities. Debt net of working capital, as used by the Company, is calculated as bank debt (if any) plus the convertible debenture of $41.94 million (as at March 31, 2017) or $57.50 million (prior to March 31, 2017) and any working capital deficit excluding unrealized derivative assets/liabilities.*

- *Operating netbacks per boe equal total petroleum and natural gas sales per boe adjusted for realized derivative gains and/or losses per boe, royalties per boe, operating expenses per boe and transportation expenses per boe. Operating netbacks are a useful measure to compare the Company's operations with those of its peers.*

- *Funds flow netbacks per boe are calculated as operating netbacks less general and administrative expenses per boe, transaction costs per boe, interest and financing charges per boe, interest on the convertible debenture per boe, cash portion of exploration and evaluation per boe, other expense per boe and current tax per boe. Funds flow netbacks per boe have been restated to exclude asset retirement expenditures per boe. Funds flow netbacks are a useful measure to compare the Company's operations with those of its peers.*

References to “production volumes” or “production” in this document refer to sales volumes.

Forward-Looking Statements – This document offers our assessment of Zargon’s future plans and operations as at May 10, 2017, and contains forward-looking statements including:

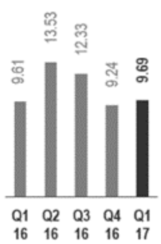
- *our expectations on our budgeted 2017 operating and transportation expenses referred to under the heading “Message to Shareholders”;*
- *our expectations for our remaining 2017 capital budget program referred to under the heading “Message to Shareholders”;*
- *our expectations for our plans with respect to our Little Bow ASP project referred to under the heading “Message to Shareholders”;*
- *our expectations for our 2017 abandonment and reclamation budget referred to under the heading “Message to Shareholders”;*
- *our expectations for our production referred to under the heading “Production Guidance”;*
- *our strategic alternatives process referred to under the headings “Strategic Alternatives Process Update” and “Outlook”; and*
- *our expected sources of funds for capital expenditures referred to under the headings “Message to Shareholders” and “Liquidity and Capital Resources”.*

Such statements are generally identified by the use of words such as “anticipate”, “continue”, “estimate”, “expect”, “forecast”, “may”, “will”, “project”, “should”, “plan”, “intend”, “believe” and similar expressions (including the negatives thereof). By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond our control, including such as those relating to results of operations and financial condition, general economic conditions, industry conditions, changes in regulatory and taxation regimes, volatility of commodity prices, escalation of operating and capital costs, currency fluctuations, the availability of services, imprecision of reserve estimates, geological, technical, drilling and processing problems, environmental risks, weather, the lack of availability of qualified personnel or management, stock market volatility, the ability to access sufficient capital from internal and external sources and competition from other industry participants for, among other things, capital, services, acquisitions of reserves, undeveloped lands and skilled personnel. Risks are described in more detail in our Annual Information Form, which is available on our website and at www.sedar.com. Forward-looking statements are provided to allow investors to have a greater understanding of our business.

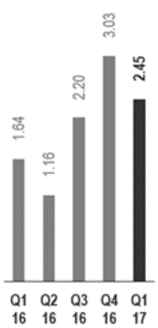
You are cautioned that the assumptions, including among other things, future oil and natural gas prices; future capital expenditure levels (including ASP); future production levels; future exchange rates; the cost of developing and expanding our assets; our ability to obtain equipment in a timely manner to carry out development activities; our ability to market our oil and natural gas successfully to current and new customers; the impact of increasing competition, our ability to obtain financing on acceptable terms; and our ability to add production and reserves through our development and acquisition activities used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Our actual results, performance, or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. We can give no assurance that any of the events anticipated will transpire or occur, or if any of them do, what benefits we will derive from them. The forward-looking information contained in this document is expressly qualified by this cautionary statement. Our policy for updating forward-looking statements is that Zargon disclaims, except as required by law, any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

This MD&A has been prepared as of May 10, 2017.

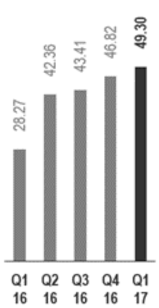
Petroleum and Natural Gas Revenue
($ millions)



Natural Gas Prices
($/mcf)



Oil and Liquids Prices
($/bbl)



FINANCIAL & OPERATING RESULTS

Petroleum and Natural Gas Sales

	Three months ended March 31,		
($ millions)	**2017**	2016	Percent Change
Petroleum sales	**8.94**	9.01	(1)
Natural gas sales	**0.75**	0.60	25
Petroleum and natural gas sales	**9.69**	9.61	1

First quarter 2017 gross petroleum and natural gas sales of $9.69 million were one percent above the $9.61 million in the first quarter of 2016 due to significantly higher oil and natural gas prices which was offset by reductions in oil and natural gas production volumes, primarily relating to property sales in the third quarter of 2016.

First quarter 2017 realized oil and liquids field prices averaged $49.30 per barrel before the impact of financial risk management contracts and were 74 percent higher than the $28.27 per barrel recorded in the 2016 first quarter. Zargon's crude oil field price differential from the Edmonton par price increased to $14.59 per barrel in the first quarter of 2017 compared to $12.78 per barrel in the first quarter of 2016. Natural gas field prices received averaged $2.45 per thousand cubic feet in the first quarter of 2017, a 49 percent increase from the 2016 first quarter prices.

Pricing

	Three Months Ended March 31,		
Average for the period	**2017**	2016	Percent Change
Natural Gas:			
NYMEX average daily spot price ($US/mmbtu)	**3.00**	1.98	52
AECO average daily spot price ($Cdn/mmbtu)	**2.69**	1.83	47
Zargon realized field price before the impact of financial risk management contracts ($Cdn/mcf)	**2.45**	1.64	49
Zargon realized field price before the impact of physical and financial risk management contracts ($Cdn/mcf)	**2.50**	1.64	52
Zargon realized natural gas field price differential before the impact of physical and financial risk management contracts ($Cdn/mcf)	**0.19**	0.19	–
Crude Oil:			
WTI ($US/bbl)	**51.91**	33.45	55
Edmonton par price ($Cdn/bbl)	**63.89**	41.05	56
Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl)	**49.30**	28.27	74
Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl)	**49.47**	33.03	50
Zargon realized oil field price differential (1)	**14.59**	12.78	14

(1) Calculated as Zargon's realized field price before the impact of financial risk management contracts ($Cdn/bbl) as compared to Edmonton par price ($Cdn/bbl).

Volumes

Oil and liquids production volumes during the 2017 first quarter were 2,016 barrels per day, a 42 percent decrease from the 2016 first quarter rate of 3,503 barrels per day. The production decrease is primarily due to the Southeast Saskatchewan and Killam, Alberta property sales that were completed in the third quarter of 2016. Natural gas production volumes decreased 16 percent in the 2017 first quarter to 3.38 million cubic feet per day compared to 4.04 million cubic feet per day in the 2016 first quarter. The natural gas production decrease is due to property sales and naturally occurring production declines.

Production by Core Area

Three Months Ended March 31,	**2017**			2016		
	Oil and Liquids (bbl/d)	**Natural Gas (mmcf/d)**	**Equivalents (boe/d)**	Oil and Liquids (bbl/d)	Natural Gas (mmcf/d)	Equivalents (boe/d)
Alberta Plains North	**563**	**1.78**	**860**	704	1.70	987
Alberta Plains South	**1,099**	**1.60**	**1,365**	1,227	2.00	1,560
Williston Basin	**354**	**–**	**354**	1,572	0.34	1,629
	2,016	**3.38**	**2,579**	3,503	4.04	4,176

Risk Management Contracts

Zargon's commodity price risk management policy, which is approved by the Board of Directors, allows for the sale of up to a certain percentage of its estimated before royalty production volumes for each commodity up to a 30 month period. Zargon may also enter into interest rate swaps.

For accounting purposes, an unrealized gain or loss from forward sale commodity contracts and interest rate swaps is recorded based on the fair value ("mark-to-market") of the contracts at the period end. Realized and unrealized gains on risk management contracts are included in "gain/loss on derivatives" in the consolidated statement of earnings/(loss) and their fair value is reflected in "derivative assets" or "derivative liabilities" on the consolidated balance sheets.

In the 2017 first quarter, higher contract prices versus WTI oil prices resulted in a net realized gain on derivatives of $0.03 million compared to a $1.44 million net realized gain in the first quarter of 2016.

The unrealized gain on derivatives in the first quarter of 2017 was related to oil contract gains of $1.83 million compared to a net $0.93 million loss ($1.03 million loss in oil and $0.10 million gain in interest rate swap) in the first quarter of 2016. These non-cash unrealized derivative gains or losses are generated by the change over the reporting period in the mark-to-market valuation of Zargon's risk management contracts. Commodity price volatility has resulted in significant fluctuations in the mark-to-market amount of unrealized derivative assets and liabilities. Zargon's commodity risk management positions are described in Notes 11 and 12 to the unaudited interim consolidated financial statements.

Royalties

	Three months ended March 31,		
($ millions)	**2017**	2016	Percent Change
Royalties	**1.00**	1.12	(11)
Percentage of revenue	**10.3%**	11.6%	

First quarter 2017 royalties are inclusive of a $0.08 million Saskatchewan Resource Surcharge ("SRC") prior period adjustment relating to sold properties. The variations in royalty rates generally track changes in production and volumes. First quarter of 2017 royalties were 10.3 percent of gross sales compared to 11.6 percent in the first quarter of 2016.

Operating Expenses and Transportation Expenses

	Three months ended March 31,		
($ millions)	**2017**	2016	Percent Change
Operating expenses	**5.08**	7.04	(28)
Transportation expenses	**0.03**	0.08	(63)
Total expenses	**5.11**	7.12	(28)
Total expenses ($/boe)	**22.01**	18.75	17

Operating expenses and transportation expenses in the 2017 first quarter were down on a total dollar basis compared to the prior year's first quarter due to a continued focus on cost reductions. In contrast, costs were up on a per barrel of oil equivalent and reflect the higher per unit cost of the remaining properties post the 2016 property sales.

Operating Netbacks

Three Months Ended March 31,	**2017**		2016	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**49.30**	**2.45**	28.27	1.64
Royalties	**(5.28)**	**(0.12)**	(3.37)	(0.12)
Realized gain on derivatives	**0.17**	**–**	4.76	–
Operating expenses	**(23.48)**	**(2.68)**	(19.10)	(2.58)
Transportation expenses	**(0.19)**	**–**	(0.27)	–
Operating netbacks	**20.52**	**(0.35)**	10.29	(1.06)

General & Administrative ("G&A") Expenses

	Three months ended March 31,		
($ millions)	**2017**	2016	Percent Change
G&A expenses	**1.16**	1.70	(32)
G&A expenses ($/boe)	**4.99**	4.48	11

G&A expenses per barrel of oil equivalent were higher in the first quarter of 2017 primarily due to lower production volumes. G&A expenses on a dollar basis were significantly lower due to 2016 staff reductions.

Transaction Costs

Transaction costs for the 2017 first quarter were $0.11 million compare to $0.03 million in the first quarter of 2016 and related to Zargon's ongoing strategic alternatives review.

Interest and Financing Charges on Bank Debt

Interest and financing income in the 2017 first quarter were $0.02 million, a 102 percent decrease from $0.63 million of the interest and financing charge in the first quarter of 2016. The decrease in interest and financing charges resulted from the termination of the credit facility in the fourth quarter of 2016.

Interest on Convertible Debentures

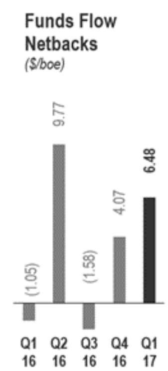
Zargon has borrowings through its convertible debentures, which were issued in May 2012 and mature on December 31, 2019. Zargon may redeem the convertible debentures with cash or through the issuance of Zargon common shares priced at 95 percent of the then current Zargon share price. Interest is payable semi-annually at a rate of six percent (eight percent effective April 1, 2017), calculated on the gross proceeds of $57.50 million ($41.94 million effective March 31, 2017). Interest charges of $0.86 million in the first quarter of 2017 were unchanged compared to the first quarter of 2016. For more details, please refer to Note 8 of the interim consolidated financial statements.

Current Tax

The current tax expense for the 2017 first quarter was nil compared to a current tax recovery of $0.01 million in the 2016 first quarter. Total corporate tax pools as at March 31, 2017 are approximately $192 million, unchanged from the comparable $192 million of tax pools available to Zargon at December 31, 2016.

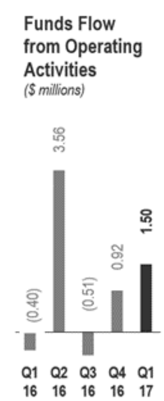
Estimated Tax Pools

($ millions)	March 31, 2017
Canadian oil and natural gas property expenses	–
Canadian development expenses	**9**
Canadian exploration expenses	**6**
Capital cost allowance	**27**
Non-capital losses	**147**
US tax pools	**1**
Other	**2**
Estimated tax pools	**192**



Corporate Netbacks

	Three Months Ended March 31,	
($/boe)	**2017**	2016
Petroleum and natural gas sales	**41.74**	25.30
Royalties	**(4.29)**	(2.95)
Realized gain on derivatives	**0.13**	3.79
Operating expenses	**(21.86)**	(18.52)
Transportation expenses	**(0.15)**	(0.23)
Operating netbacks	**15.57**	7.39
General and administrative expenses	**(4.99)**	(4.48)
Transaction costs	**(0.46)**	(0.08)
Interest and financing charges	**0.06**	(1.64)
Interest on convertible debentures	**(3.70)**	(2.27)
Current tax recovery	**–**	0.03
Funds flow netbacks	**6.48**	(1.05)



Depletion and Depreciation Expense

Depletion and depreciation expense for the first quarter of 2017 decreased 46 percent at $3.41 million compared to $6.37 million in the first quarter of 2016. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $14.69 and $16.76 for the first quarter of 2017 and the first quarter of 2016, respectively. When compared to the first quarter of 2016, the decreased depletion rate is primarily due to the property sales in the third quarter of 2016. The 2016 calendar year depletion and depreciation rate was $15.54 per barrel of oil equivalent.

Accretion of Asset Retirement Obligations and Convertible Debentures

The accretion expense of asset retirement obligations for the first three months of 2017 was $0.37 million, a 24 percent decrease from the first three months of 2016. On a per barrel of oil equivalent basis, the accretion expenses were $1.60 and $1.29 for the first quarter of 2017 and the first quarter of 2016, respectively. Year-over-year adjustments are due to property sales in the third quarter of 2016 and changes in the estimated future liability for asset retirement obligations resulting from changes in cost assumptions and adjustments in Zargon's well count due to drilling programs and property acquisitions or dispositions.

The debt portion of Zargon's convertible debenture is also accreted over its term, up to the total maturity value of $57.50 million ($41.94 million effective March 31, 2017). Accretion on the convertible debenture for the 2017 first quarter is $0.37 million compared to $0.37 million in the 2016 first quarter. For more details, please refer to Note 8 of the interim consolidation financial statements.

Shared-based Compensation

Expensing of share-based compensation in the first quarter of 2017 totalled $0.05 million, which is lower than the $0.15 million incurred in the first quarter of 2016.

Unrealized Foreign Exchange

The Company had an unrealized foreign exchange loss of $0.04 million during the first quarter of 2017 compared to a loss of $0.57 million in the 2016 first quarter. Gains and losses result from transactions in US dollars when they are translated into Canadian dollars. The volatility in the US/Cdn dollar creates non-cash translation gains/losses.

Exploration and Evaluation Expenses

Non-cash exploration and evaluation expenses for the 2017 first quarter of $0.05 million compared to first quarter of 2016 expenses of $0.04 million. Exploration and evaluation expenses are primarily related to undeveloped land expiries. The 2017 first quarter exploration and evaluation expense primarily related to expiries in North Dakota and Alberta.

Gain on Convertible Debenture

As a result of the current quarter's convertible debenture amendments, the Company recognized a gain of $0.46 million. The Company amended its convertible debentures which extended the maturity date to December 31, 2019 from June 30, 2017, increased the interest rate to eight percent from six percent, and reduced the conversion price on conversion of the debentures to $1.25 from $18.80 and the redemption of $15.56 million face value for $14.84 of cash. For more details, please refer to Note 8 of the interim consolidation financial statements.

Impairment Loss on Marketable Securities

As at March 31, 2017, the Company tested its marketable securities for impairment. Decreased values in market capitalization resulted in impairment of marketable securities. The fair value of the marketable securities were estimated at March 31, 2017 with the book value estimated at the time they were acquired or previously written-down.

Based on the assessment on March 31, 2017, the carrying amounts of marketable securities were determined to be $0.14 million higher than their recoverable amount of $0.05 million, and an impairment loss was recognized.

Deferred Tax

The deferred tax recovery for the first quarter of 2017 was $0.10 million compared to a recovery of $0.49 million in the first quarter of 2016. The deferred tax recovery is a result of the net loss in the quarter.

Funds Flow from Operating Activities

Funds flow from operating activities in the 2017 first quarter was $1.50 million and was $1.90 million, or 475 percent higher than the prior year first quarter. Funds flow from operating activities has been restated to exclude asset retirement expenditures. The increase in funds flow compared to the prior year first quarter was primarily a result of improved oil prices.

Net Loss

A net loss of $0.54 million for the 2017 first quarter was $8.28 million higher than the $8.82 million net loss in the 2016 first quarter, largely due to higher unrealized derivative gains, lower operating expenses, gain on convertible debentures, G&A expenses, interest expenses and depletion and depreciation. The net earnings/(loss) track the funds flow from operating activities for the respective periods and non-cash charges, which include depletion and depreciation, unrealized derivative gain/(loss), land expiries, accretion, gain on convertible debentures and deferred taxes. On a per diluted share basis, the 2017 first quarter net loss was $0.02, compared to a net loss of $0.29 from the 2016 first quarter.

Capital Expenditures

	Three Months Ended March 31,	
($ millions)	**2017**	2016
Undeveloped land	**0.49**	0.46
Geological and geophysical (seismic)	**0.16**	0.04
Drilling and completion of wells	**0.34**	0.01
Well equipment and facilities	**0.49**	(0.08)
ASP project and exploitation costs	**0.35**	0.18
ASP chemical costs	**0.54**	1.82
Exploration and development	**2.37**	2.43
Property acquisitions	**0.13**	0.04
Property dispositions	**–**	–
Net property acquisitions	**0.13**	0.04
Total net capital expenditures excluding administrative assets	**2.50**	2.47
Administrative assets	**0.01**	–
Total net capital expenditures	**2.51**	2.47

LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property acquisitions) totalled $2.51 million in the first quarter of 2017 and were two percent higher than the same period in 2016. Field expenditures of $2.37 million for the first quarter of 2017 were two percent lower than the 2016 first quarter. The first quarter 2017 field capital expenditures (excluding net property acquisitions) were allocated to Alberta Plains North - $0.38 million, Alberta Plains South - $1.72 million and Williston Basin - $0.27 million and included the drilling of nil net wells, unchanged from the first quarter of 2016.

Included in the Alberta Plains South capital expenditures is the $0.89 million incurred on the Little Bow ASP project. Of the total ASP amount, $0.35 million was spent on project and exploitation costs while $0.54 million was spent on chemical costs for the facility.

At March 31, 2017, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $35.09 million, which compares to $33.51 million of net debt at the end of December 31, 2016. The $35.09 million debt net of working capital consists of the $41.94 million of convertible unsecured subordinate debentures, which is partially offset by net cash balances.

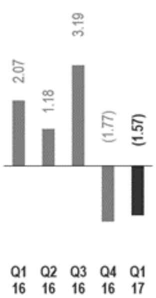
Zargon's restricted cash represents cash amounts used as collateral for the Company's letters of credit.

The Company has borrowings through its convertible debentures, which mature on December 31, 2019. Zargon may redeem the convertible debentures with cash or through the issuance of Zargon common shares priced at 95 percent of the then current Zargon share price. Interest is payable semi-annually at a rate of six percent (eight percent effective April 1, 2017), calculated on the gross proceeds of $57.50 million ($41.94 million effective March 31, 2017).

The volatility of oil and natural gas prices, uncertainty or modifications regarding royalties and Canadian income tax rules and global economic/political concerns have, on occasion, restricted the oil and natural gas industry's ability to attract new capital from debt and equity markets.

Zargon's operational results and financial condition, and, therefore, the funds available to be allocated to capital expenditures, are dependent on the prices received for oil and natural gas production.

Cash Flows from Operating Activities
($ millions)



For the quarter ended March 31, 2017, net capital expenditures totalled $2.51 million, which was $4.08 million higher than the cash flows from operating activities (after changes in non-cash working capital) of negative $1.57 million. For the quarter ended March 31, 2016, net capital expenditures totalled $2.47 million, which was $0.40 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $2.07 million. Zargon relies on access to debt and capital markets to the extent that net capital expenditures exceed cash flows from operating activities (after changes in non-cash working capital). Over the long term, Zargon expects to fund capital expenditures with its cash flows from operating activities; however, it may fund growth through additional debt and equity issuances. In the crude oil and natural gas industry, because of the nature of reserve reporting, the natural reservoir declines and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities. Therefore, maintenance capital is not disclosed separately from development capital spending.

At May 10, 2017, Zargon Oil & Gas Ltd. had 30.72 million common shares outstanding. Pursuant to the stock option plan and the share award plan, there are currently an additional 0.45 million common share awards issued and outstanding and 1.34 million stock options issued and outstanding.

Capital Sources and Uses

	Three Months Ended March 31,	
($ millions)	**2017**	2016
Funds flow from/(used in) operating activities	**1.50**	(0.40)
Change in long term bank debt	–	4.36
Change in cash	**14.68**	–
Change in convertible debenture	**(13.37)**	–
Asset retirement costs	**(0.14)**	0.12
Changes in working capital and other	**(0.16)**	(1.61)
Total capital sources	**2.51**	2.47

CHANGES IN ACCOUNTING POLICIES

The Company's changes in accounting policies are discussed in Note 3 to the Financial Statements.

FUTURE CHANGES IN ACCOUNTING POLICIES

The Company's future changes in accounting policies are discussed in Note 3 to the Financial Statements.

MANAGEMENT AND FINANCIAL REPORTING SYSTEMS

Zargon is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings", otherwise referred to as Canadian SOX ("C-Sox"). The 2017 certificate requires that the Company disclose in the interim MD&A any changes in the Company's internal controls over financial reporting that occurred during the period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. The Company confirms that no such changes were made to the internal controls over financial reporting during the first quarter of 2017.

Because of their inherent limitations, internal controls over financial reporting may not prevent or detect misstatements, errors or fraud. Control systems, no matter how well conceived or operated, can provide only reasonable, not absolute assurance that the objectives of the control systems are met. Zargon uses the 2013 Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Framework.

OUTLOOK

In 2015, Zargon announced the formation of a Special Board Committee (the "Committee") to examine alternatives that would maximize shareholder value in a manner that would recognize the Company's fundamental inherent value related to Zargon's long-life, low-decline conventional oil assets and the significant long term oil potential related to the Little Bow ASP project.

Last year's $92.04 million of property sales and this year's partial repayment and amendment of Zargon's convertible debentures were a partial outcome of this process. With the debenture restructuring and elimination of bank debt now completed, the strategic alternatives process is continuing and may include a sale of the Company or a portion of the Company's assets, a restructuring of the Company's current capital structure, the addition of capital to further develop the potential of the assets, a merger, a farm-in or joint venture, or other such options as may be determined by the Company's Board of Directors to be in the best interests of the Company and its stakeholders. Zargon's Special Board Committee has engaged Macquarie Capital Markets Canada Ltd. ("Macquarie") as its exclusive financial advisor related to this component of its strategic alternatives process. The Company has not set a definitive schedule to complete its evaluation and no decision on any particular alternative has been reached at this time. Zargon does not intend to disclose developments with respect to this process unless and until the Board of Directors has approved a definitive transaction or other course of action or otherwise deems disclosure of developments is appropriate or otherwise required by law. There are no guarantees that the process will result in a transaction of any form or, if a transaction is entered into, as to its terms or timing.

SUMMARY OF QUARTERLY RESULTS

	2016				2017
	Q1	Q2	Q3	Q4	**Q1**
Petroleum and natural gas sales ($ millions)	9.61	13.53	12.33	9.24	**9.69**
Net (loss)/earnings ($ millions)	(8.82)	(5.27)	13.81	(17.81)	**(0.54)**
Net (loss)/earnings per diluted share ($)	(0.29)	(0.17)	0.44	(0.58)	**(0.02)**
Funds flow from/(used in) operating activities ($ millions) (2)	(0.40)	3.56	(0.51)	0.92	**1.50**
Funds flow from/(used in) operating activities per diluted share ($) (2)	(0.01)	0.12	(0.01)	0.03	**0.05**
Cash flows from operating activities ($ millions)	2.07	1.18	3.19	(1.77)	**(1.57)**
Cash flows from operating activities per diluted share ($)	0.07	0.04	0.12	(0.06)	**(0.05)**
Net capital expenditures/(dispositions) ($ millions)	2.47	1.26	(90.29)	1.43	**2.51**
Total assets ($ millions)	255.14	253.94	218.38	169.39	**153.75**
Bank debt ($ millions)	64.59	65.08	30.00	–	–
Convertible debentures ($ millions) (1)	57.50	57.50	57.50	57.50	**41.94**
Net debt	124.37	122.26	32.99	33.51	**35.09**
Average daily oil and liquids production (bbl)	3,503	3,413	2,915	1,952	**2,016**
Average daily natural gas production (mmcf)	4.04	3.58	3.39	2.98	**3.38**
Average daily production (boe)	4,176	4,010	3,480	2,449	**2,579**
Average oil production weighting (%)	84	85	84	80	**78**
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	25.30	37.09	38.50	41.01	**41.74**
Funds flow netback ($/boe) (2)	(1.05)	9.77	(1.58)	4.07	**6.48**

(1) Amount is full future face value of the convertible debentures, $41.94 million as at March 31, 2017 or $57.50 million prior to March 31, 2017.

(2) Funds flow from operating activities and funds flow netback have been restated to exclude asset retirement expenditures.

	2015			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales ($ millions)	16.41	20.32	16.23	14.40
Net loss ($ millions)	(4.88)	(3.76)	(41.16)	(56.34)
Net loss per diluted share ($)	(0.16)	(0.12)	(1.36)	(1.86)
Funds flow from operating activities ($ millions) (3)	8.73	10.26	3.65	3.94
Funds flow from operating activities per diluted share ($) (3)	0.29	0.34	0.12	0.13
Cash flows from operating activities ($ millions)	6.67	6.98	7.65	(1.05)
Cash flows from operating activities per diluted share ($)	0.22	0.23	0.25	(0.03)
Cash dividends ($ millions) (1)	2.72	2.73	0.91	0.30
Cash dividends declared per common share ($)	0.09	0.09	0.03	0.01
Net capital expenditures ($ millions)	5.40	5.35	7.38	7.75
Total assets ($ millions)	377.16	369.47	325.64	263.66
Long term bank debt ($ millions)	49.91	50.80	51.98	60.24
Convertible debentures ($ millions) (2)	57.50	57.50	57.50	57.50
Net debt	113.80	111.99	116.96	121.06
Average daily oil and liquids production (bbl)	3,928	3,720	3,633	3,635
Average daily natural gas production (mmcf)	5.24	5.32	5.28	4.23
Average daily production (boe)	4,802	4,607	4,513	4,340
Average oil production weighting (%)	82	81	81	84
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	37.98	48.46	39.08	36.05
Funds flow netback ($/boe) (3)	20.19	24.48	8.80	9.85

(1) Cash dividends were suspended after the October 2015 dividend paid on November 16, 2015.

(2) Amount is full future face value of the convertible debentures, $41.94 million as at March 31, 2017 or $57.50 million prior to March 31, 2017.

(3) Funds flow from operating activities and funds flow netback have been restated to exclude asset retirement expenditures.

Additional information regarding the Company and its business operations, including the Company's Annual Information Form for December 31, 2016, is available on the Company's SEDAR profile at www.sedar.com.

"Signed" C.H. Hansen
President and Chief Executive Officer

Calgary, Alberta
May 10, 2017

CONSOLIDATED BALANCE SHEETS

(unaudited)

($ thousands)	Notes	**March 31, 2017**	December 31, 2016
ASSETS			
Cash and cash equivalents		**9,644**	23,919
Restricted cash		**529**	936
Trade and other receivables	11	**3,892**	3,485
Deposits and prepaid expenses		**520**	836
Investment in marketable securities	11	**50**	185
Total current assets		**14,635**	29,361
Long term deposits		**731**	328
Property, plant and equipment, net	5	**136,087**	137,479
Intangible exploration and evaluation assets	6	**2,296**	2,226
Total assets		**153,749**	169,394
LIABILITIES			
Trade and other payables	11	**7,786**	5,366
Convertible debentures	8,11	**–**	56,671
Derivatives	11,12	**119**	1,948
Total current liabilities		**7,905**	63,985
Convertible debentures	8,11	**41,239**	–
Asset retirement obligations	7	**66,719**	66,749
Deferred tax liabilities		**4,183**	4,318
Total liabilities		**120,046**	135,052
Commitments and contingencies	7,12		
EQUITY			
Shareholders' capital	9	**261,796**	260,902
Accumulated other comprehensive income		**4,849**	4,928
Contributed surplus	10	**9,773**	10,614
Equity component of debentures	8	**3,570**	3,640
Deficit		**(246,285)**	(245,742)
Total equity		**33,703**	34,342
Total equity and liabilities		**153,749**	169,394

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF EARNINGS/(LOSS) AND COMPREHENSIVE INCOME/(LOSS)

(unaudited)		Three Months Ended March 31,	
($ thousands, except per share amounts)	Notes	**2017**	2016
Petroleum and natural gas sales		**9,689**	9,614
Royalties		**(996)**	(1,120)
PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES		**8,693**	8,494
Gain/(loss) on unrealized derivatives	11,12	**1,829**	(926)
Gain on realized derivatives	11,12	**31**	1,437
GAIN ON DERIVATIVES		**1,860**	511
TOTAL INCOME		**10,553**	9,005
Operating		**5,075**	7,036
Transportation		**35**	86
General and administrative		**1,159**	1,701
Transaction costs		**107**	29
Exploration and evaluation	6	**50**	42
Gain on convertible debentures	8	**(458)**	–
Share-based compensation	10	**53**	149
Unrealized foreign exchange loss		**37**	566
Impairment loss on marketable securities		**135**	–
Depletion and depreciation	5	**3,410**	6,369
EXPENSES		**9,603**	15,978
EARNINGS/(LOSS) BEFORE FINANCE EXPENSES AND INCOME TAXES		**950**	(6,973)
Interest and financing charges		**(15)**	625
Interest on convertible debentures	8	**860**	863
Accretion on convertible debentures	8	**373**	370
Accretion of asset retirement obligations	7	**371**	488
FINANCE EXPENSES		**1,589**	2,346
LOSS BEFORE INCOME TAXES		**(639)**	(9,319)
Current tax recovery		**–**	(12)
Deferred tax recovery		**(96)**	(486)
INCOME TAXES RECOVERY		**(96)**	(498)
NET LOSS FOR THE PERIOD		**(543)**	(8,821)
Currency translation adjustment recognized in other comprehensive loss		**(79)**	(630)
OTHER COMPREHENSIVE LOSS FOR THE PERIOD		**(79)**	(630)
TOTAL COMPREHENSIVE LOSS FOR THE PERIOD		**(622)**	(9,451)
NET LOSS PER SHARE			
Basic		**(0.02)**	(0.29)
Diluted		**(0.02)**	(0.29)

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited)

($ thousands)	Notes	Shareholders' Capital	Accumulated Other Comprehensive Income	Contributed Surplus	Equity Component of Convertible Debentures	Deficit	Total Equity
Balance at December 31, 2016		**260,902**	**4,928**	**10,614**	**3,640**	**(245,742)**	**34,342**
Net loss for the period		**–**	**–**	**–**	**–**	**(543)**	**(543)**
Share-based compensation	10	**–**	**–**	**53**	**–**	**–**	**53**
Exercise of share awards	9	**894**	**–**	**(894)**	**–**	**–**	**–**
Equity component of convertible debentures	8	**–**	**–**	**–**	**(70)**	**–**	**(70)**
Translation differences on foreign subsidiary		**–**	**(79)**	**–**	**–**	**–**	**(79)**
Balance at March 31, 2017		**261,796**	**4,849**	**9,773**	**3,570**	**(246,285)**	**33,703**
Balance at December 31, 2015		259,149	5,249	12,198	3,640	(227,655)	52,581
Net loss for the period		–	–	–	–	(8,821)	(8,821)
Share-based compensation	10	–	–	149	–	–	149
Exercise of share awards	9	776	–	(776)	–	–	–
Translation differences on foreign subsidiary		–	(630)	–	–	–	(630)
Balance at March 31, 2016		259,925	4,619	11,571	3,640	(236,476)	43,279

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)		Three Months Ended March 31,	
($ thousands)	Notes	**2017**	2016
OPERATING ACTIVITIES			
Net loss for the period		**(543)**	(8,821)
Adjustments for non-cash items:			
Gain on convertible debenture	8	**(458)**	–
(Gain)/loss on unrealized derivatives	11,12	**(1,829)**	926
Depletion and depreciation	5	**3,410**	6,369
Accretion of asset retirement obligations	7	**371**	488
Accretion of convertible debentures	8	**373**	370
Share-based compensation	10	**53**	149
Unrealized foreign exchange loss		**37**	566
Impairment loss on marketable securities		**135**	–
Deferred tax recovery		**(96)**	(486)
Exploration and evaluation expenses	6	**50**	42
Funds flow from/(used in) operating activities		**1,503**	(397)
Asset retirement (expenditures)/recovery	7	**(143)**	116
Changes in operating working capital		**(2,930)**	2,348
Net cash (used in)/from operating activities		**(1,570)**	2,067
INVESTING ACTIVITIES			
Additions to property, plant and equipment	5	**(2,383)**	(2,409)
Additions to intangible exploration and evaluation assets	6	**(123)**	(62)
Change in restricted cash		**407**	–
Change in long term deposits		**(403)**	–
Changes in investing working capital		**1,120**	(3,952)
Net cash used in investing activities		**(1,382)**	(6,423)
FINANCING ACTIVITIES			
Advances of bank debt		**–**	4,356
Redemption of convertible debentures, including transaction costs	8	**(13,370)**	–
Changes in financing working capital	8	**2,047**	–
Net cash (used in)/provided by financing activities		**(11,323)**	4,356
NET CHANGE IN CASH DURING THE PERIOD		**(14,275)**	–
CASH, BEGINNING OF PERIOD		**23,919**	–
CASH, END OF PERIOD		**9,644**	–

See accompanying notes to the interim consolidated financial statements.

For the three months ended March 31, 2017, with comparative figures for 2016 (unaudited).

1. REPORTING ENTITY

Zargon Oil & Gas Ltd. ("the Company" or "Zargon") is a publicly traded corporation incorporated in Canada with its head office located at Suite 700, 333-5th Avenue SW, Calgary, Alberta. The interim consolidated financial statements of the Company as at and for the period ended March 31, 2017 and for its 2016 comparative period comprise the Company and its wholly owned subsidiaries. The Company is engaged in the exploration for and development and production of oil and natural gas in Canada and the United States ("US") and conducts many of its activities jointly with others; these financial statements reflect only the Company's proportionate interest in such activities.

2. BASIS OF PRESENTATION

(a) Statement of compliance:

The unaudited interim consolidated financial statements for the three month period ended March 31, 2017 have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") applicable to the preparation of interim financial statements, including International Accounting Standards ("IAS") 34, Interim Financial Reporting. The same accounting policies and methods of computation were followed in the preparation of these unaudited interim consolidated financial statements as were followed in the preparation of the audited annual consolidated financial statements for the fiscal year ended December 31, 2016. New and amended accounting standards have been evaluated and disclosed in Note 3. The disclosures provided below are incremental to those included with the audited annual consolidated financial statements. These unaudited interim consolidated financial statements for the three month period ended March 31, 2017 should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2016. These consolidated financial statements were approved and authorized for issue by the Board of Directors on May 10, 2017.

(b) Basis of measurement:

The interim consolidated financial statements have been prepared on the historical cost basis except for the derivative financial instruments and the investment in marketable securities which are measured at fair value.

(c) Functional and presentation currency:

Items included in the financial statements of each consolidated entity are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The interim consolidated financial statements are presented in Canadian dollars, which is Zargon's functional currency.

The financial statements of subsidiaries that have a functional currency different from that of Zargon ("foreign operations") are translated into Canadian dollars as follows: assets and liabilities - at the closing rate at the date of the balance sheet, and income and expenses - at the average rate of the period (as this is considered a reasonable approximation to actual rates). All resulting changes are recognized in other comprehensive income as currency translation adjustments.

If Zargon disposes of its entire interest in a foreign operation, or loses control, joint control, or significant influence over a foreign operation, the foreign currency gains or losses accumulated in other comprehensive income related to the foreign operation are recognized in earnings. If Zargon disposes of part of an interest in a foreign operation which remains a subsidiary, a proportionate amount of foreign currency gains or losses accumulated in other comprehensive income related to the subsidiary are reallocated between controlling and non-controlling interests.

(d) Use of estimates and judgements:

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

3. ACCOUNTING POLICIES

(a) New and amended standards adopted by the Company:

No new or amended standards were adopted by the Company for the interim period.

(b) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Company:

- IFRS 9 "Financial Instruments" replaces the current multiple classification and measurement models for financial assets and liabilities with a single model. IFRS 9 also details the new general hedge accounting model. Hedge accounting remains optional and the new model is intended to allow reporters to better reflect risk management activities in the financial statements and provide more opportunities to apply hedge accounting. The Company does not employ hedge accounting for its risk management contracts currently in place. IFRS 9 will be effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.
- IFRS 15 "Revenue from Contracts with Customers" specifies how and when to recognize revenue as well as requiring entities to provide users of financial statements with more informative, relevant disclosures. The standard supersedes IAS 18 "Revenue", IAS 11 "Construction Contracts" and a number of revenue-related interpretations. IFRS 15 will be effective for annual periods beginning on or after January 1, 2018 with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.
- IFRS 16 "Leases", was issued by IASB in January 2016, which replaces IAS 17 "Leases". For lessees applying IFRS 16, a single recognition and measurement model for leases would apply, with required recognition of assets and liabilities for most leases. The standard will come into effect for annual periods beginning on or after January 1, 2019, with earlier adoption permitted if the entity is also applying IFRS 15 "Revenue from Contracts with Customers". The Company has not yet determined the impact on the Company's consolidated financial statements.

4. RESTRICTED CASH

Restricted cash represents cash amounts used as collateral for the Company's letters of credit.

5. PROPERTY, PLANT AND EQUIPMENT

($ thousands)

Cost, December 31, 2016	**291,731**
Accumulated depletion and depreciation	**(154,252)**
Net carrying amount, December 31, 2016	**137,479**
Additions	**2,383**
Change in asset retirement obligation	**(193)**
Exchange differences	**(172)**
Depletion and depreciation	**(3,410)**
Net carrying amount, March 31, 2017	**136,087**
Cost, March 31, 2016	**293,584**
Accumulated depletion and depreciation	**(157,497)**
Net carrying amount, March 31, 2017	**136,087**

6. INTANGIBLE EXPLORATION AND EVALUATION ASSETS

($ thousands)	
Cost, December 31, 2016	**2,226**
Additions	**123**
Exploration and evaluation expense	**(50)**
Exchange differences	**(3)**
Cost, March 31, 2017	**2,296**

7. ASSET RETIREMENT OBLIGATIONS

($ thousands)	
Balance at December 31, 2016	**66,749**
Foreign exchange and other	**(65)**
Asset retirement obligations recovered during the period	**(143)**
Revisions to estimated asset retirement obligations	**(193)**
Accretion	**371**
Balance at March 31, 2017	**66,719**

The asset retirement obligations were calculated using a discount factor of 2.25 percent (December 31, 2016 – 2.25 percent) being the risk-free rate related to the liability and based on the Government of Canada long term bond rate. These obligations are expected to be incurred over the next 55 years. An inflation rate of two percent per annum (December 31, 2016 – two percent) used in the calculation of the present value of the asset retirement obligation remains unchanged.

8. CONVERTIBLE DEBENTURES

On May 1, 2012, Zargon completed the issuance of convertible unsecured subordinated debentures (the "debentures") for gross proceeds of $50.00 million (net proceeds of $47.45 million after transaction costs) at a price of $1,000 per debenture. On May 4, 2012, Zargon completed the issuance of the over-allotment of the convertible unsecured subordinated debentures for gross proceeds of $7.50 million (net proceeds of $7.20 million) at a price of $1,000 per debenture. The debentures bore interest at a rate of six percent per annum, which was payable semi-annually, in arrears, on June 30 and December 31 of each year which commenced December 31, 2012. The debentures were convertible at the holder's option into common shares of Zargon at a conversion price of $18.80 per common share and were to mature on June 30, 2017.

After June 30, 2015, Zargon could have redeemed the debentures in whole or in part provided the common shares' weighted average trading price during a specified period prior to redemption was not less than 125 percent of the conversion price. Zargon could also have redeemed the debentures on June 30, 2017 with cash or through the issuance of Zargon common shares priced at 95 percent of the current market price of the common shares on the maturity date.

The debentures have been classified as debt, net of issuance costs with the residual value allocated to shareholders' equity. The issuance costs will be amortized over the term of the debentures and the debt portion will accrete up to the principal balance at maturity. The accretion of the convertible debentures and the interest paid are expensed on the consolidated statements of earnings/(loss) and comprehensive income/(loss).

As of February 14, 2017, amendments to the debentures (the "amended debentures") took effect, which were more particularly described in the Company's information circular dated January 16, 2017 (the "Information Circular") and as approved by the Debentureholders at a meeting held February 14, 2017. The debentures now have an annual interest rate of eight percent effective April 1, 2017, a conversion price of $1.25, a maturity date of December 31, 2019 and are subject to other changes as further described in the Information Circular (available on the Company's SEDAR profile at www.sedar.com). The amendments were accounted for as a modification and additional costs of $0.58 million will be amortized over the extended term of the debenture at an amended effective interest rate of 8.6 percent.

On March 31, 2017, Zargon took up $15.56 million aggregate principal amount of its six percent convertible unsecured subordinated debentures at tender prices ranging from $890 to $1,000 per $1,000 principal amount of debentures, for a total cash consideration of $14.84 million, which was equivalent to an average cost of $954 per debenture. The redemption of the debentures was completed pursuant to the Company's previously announced redemption of up to $19.00 million aggregate principal amount of debentures at cash prices determined by a "Dutch auction" process (the "Redemption Auction").

The amended debentures were commenced trading on the Toronto Stock Exchange under the new symbol "ZAR.DB.A" at the open of markets on April 3, 2017. After giving effect to the Redemption Auction, there was approximately $41.94 million aggregate principal amount of the amended debentures outstanding.

($ thousands)	March 31, 2017	December 31, 2016
Principal, beginning of year	**57,500**	57,500
Redemption	**(15,559)**	–
Principal, end of period	**41,941**	57,500
Debt component, beginning of year	**56,671**	55,129
Cash consideration	**(12,795)**	–
Accrued liability for cash consideration	**(2,047)**	–
Gain on convertible debenture	**(458)**	–
Transaction costs	**(505)**	–
Accretion of convertible debentures	**373**	1,542
Debt component, end of period	**41,239**	56,671
Equity component, beginning of year	**3,640**	3,640
Transaction costs	**(70)**	–
Equity component, end of period	**3,570**	3,640

9. SHARE CAPITAL

The Company is authorized to issue an unlimited number of voting common shares and 10.00 million preferred shares.

Common Shares

	Three Months Ended March 31, 2017	
(thousands)	Number of Shares	Amount ($)
Balance, as at December 31, 2016	**30,607**	**260,902**
Share awards exercised	**109**	**–**
Share-based compensation transferred from contributed surplus on exercise of share awards	**–**	**894**
Balance, as at March 31, 2017	**30,716**	**261,796**

10. SHARE-BASED PAYMENTS

Stock Option Plan

On March 24, 2017, Zargon granted an aggregate of 1.34 million stock options to our directors, officers and certain employees at an exercise price of $0.72 per share under the Plan. Of these, 0.32 million options were granted to our non-management directors, 0.54 million options were granted to our officers and the balance of 0.48 million stock options were granted to various employees. One-third of the options vest on December 31, 2017, one-third on December 31, 2018 and the balance on December 31, 2019. Zargon uses a fair value methodology to value the stock options. The assumptions made for the stock options include a volatility factor of 64 percent, a risk free rate of one percent and a forfeiture rate of nil. In the event that this grant is not ratified by our shareholders, we may consider other forms of cash compensation in lieu of these options.

In order to be passed, the ordinary resolution must be approved by a majority of the aggregate votes cast by shareholders at the meeting on May 30, 2017. It is the intention of the persons named in the enclosed form of proxy, if named as proxy and not expressly directed to the contrary in the form of proxy, to vote those proxies in favour of the above resolution.

Assuming approval of the Plan, the total number of common shares that will be available for stock option grants following the meeting will be 667,510 common shares (eight percent of our issued and outstanding common shares as at April 17, 2017 less 449,745 common shares currently reserved for issuance on outstanding share awards and the 1.34 million stock options granted under the Plan that are subject to ratification at the meeting).

The following table summarizes information about the Company's stock options under the Stock Option Plan:

	Three Months Ended March 31, 2017
	Number of Stock Options (thousands)
Outstanding, as at December 31, 2016	**–**
Share awards granted	**1,340**
Outstanding, as at March 31, 2017	**1,340**

SHARE AWARD PLAN

Under the Share Award Plan, directors, officers, employees and other service providers (the "grantees") are granted the right to receive a defined number of shares in the future, which increases commensurately with each dividend declared by the Company after the grant date. The grantees will receive equity compensation in relation to the value of a specified number of underlying share awards. The awards vest equally over four years and expire five years after grant date. Holders may choose to exercise upon vesting or at any time thereafter, with forfeiture of any shares not exercised by the expiry date. Upon vesting, the grantees are eligible to receive a share award based on the fair value of the underlying share awards plus all notional dividends accrued since the grant date. Zargon uses a fair value methodology to value the share awards.

Due to the nature of the plan, Zargon is required to estimate the forfeiture rate upon initial calculation of fair values. The forfeiture rate is estimated at 15 percent while the interest rate and volatility is set at a historical rate as there is no exercise price. The fair value of the share award is determined on the grant date at the prior day closing price of the Company's common shares on the Toronto Stock Exchange.

The following table summarizes information about the Company's share awards under the Share Award Plan:

	Three Months Ended March 31, 2017
	Number of Share Awards (thousands)
Outstanding, as at December 31, 2016	**544**
Share awards granted	**25**
Share awards exercised	**(109)**
Share awards forfeited	**(10)**
Outstanding, as at March 31, 2017	**450**

Share-based Compensation

The stock options/share awards for the three months ended March 31, 2017, resulted in share-based compensation of $0.05 million (2016 - $0.15 million).

Compensation expense associated with stock options/share awards granted is recognized in earnings over the vesting period with a corresponding increase in contributed surplus. The exercise of stock options/share awards is recorded as an increase in common shares with a corresponding reduction in contributed surplus.

Weighted Average Number of Total Shares

	Three Months Ended March 31,	
(thousands of shares)	**2017**	2016
Weighted average number of common shares – basic	**30,668**	30,440
Weighted average number of common shares – diluted	**30,806**	30,440

Dilution amounts for the three months ended March 31, 2017 of 0.14 million shares (2016 – nil) were added to the weighted average number of shares outstanding during the period in the calculation of diluted per share amounts. These share additions represent the dilutive effect of share rights according to the treasury stock method.

The convertible debenture could potentially dilute basic earnings per share, but were not included in the calculation of diluted earnings per share because they are antidilutive for the three months ended March 31, 2017 and 2016.

11. FINANCIAL INSTRUMENTS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgement.

The following table shows the comparison of the carrying and fair value of the company's financial instruments:

	March 31, 2017		December 31, 2016	
(thousands)	**Carrying Value ($)**	**Fair Value ($)**	Carrying Value ($)	Fair Value ($)
Loans and receivables:				
Trade and other receivables	**3,892**	**3,892**	3,485	3,485
Fair value through profit and loss:				
Derivative assets	**–**	**–**	–	–
Derivative liabilities	**119**	**119**	1,948	1,948
Fair value through other comprehensive income:				
Investment in marketable securities	**50**	**50**	185	185
Other liabilities:				
Trade and other payables	**7,786**	**7,786**	5,366	5,366
Convertible debentures	**41,239**	**37,957**	56,671	49,881

All of the Company's risk management contracts are transacted in active markets. The Company classifies the fair value of these transactions according to the following hierarchy based on the amount of observable inputs used to value the instrument.

The investment in marketable securities is classified as "available-for-sale" and is carried at fair value. This investment is available on the active market and the Company classifies the fair value of this investment according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level I

  Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and value to provide pricing information on an ongoing basis.

- Level II

  Pricing inputs are other than quoted prices in active markets included in Level I. Prices in Level II are either directly or indirectly observable as of the reporting date. Level II valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the market place.

- Level III

  Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The Company's risk management contracts have been assessed on the fair value hierarchy described above and are classified as Level II. Assessment of the significance of a particular input into the fair value measurement requires judgment and may affect the placement within the fair value hierarchy level. The Company's policy is to recognize transfers into and out of fair value hierarchy levels as of the date of the event or change in circumstances that caused the transfer. The company does not have any financial instruments classified as Level III.

At each reporting date, the Company determines whether transfers have occurred between levels in the hierarchy by reassessing the level of classification for each financial asset and financial liability measured or disclosed at fair value in the consolidated financial statements. Assessment of the significance of a particular input to the fair value measurement requires judgement and may affect the placement within the fair value hierarchy. During the period ended March 31, 2017, there were no transfers between levels I, II or III.

The carrying value of receivables and other liabilities approximate their fair value due to their short maturities, except for the convertible debentures which are determined using Level I inputs.

Financial Risk Management

The Company is exposed to financial risks arising from its financial assets and liabilities. The financial risks include market risk (commodity prices, interest rates and foreign exchange rates), credit risk and liquidity risk.

- Market Risk

  Market risk is the risk that the fair value of future cash flows of financial assets or liabilities will fluctuate due to movements in market prices and is comprised of the following:

  \- Commodity Price Risk

  Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result in changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, but also world economic events that dictate the levels of supply and demand. As a means of mitigating exposure to commodity price risk volatility, the Company has entered into various derivative agreements. The use of derivative instruments is governed under formal policies and is subject to limits established by the Board of Directors. The Company's policy is to not use derivative financial instruments for speculative purposes.

  Natural Gas – To partially mitigate the natural gas commodity price risk, the Company may enter into swaps, which fix the Canadian dollar AECO prices, and natural gas basis hedges.

  Crude Oil – The Company has partially mitigated its exposure to the WTI NYMEX price with fixed price swaps.

  \- Interest Rate Risk

  Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. Borrowings under bank credit facilities are market rate based (variable interest rates); thus, carrying values approximate fair values.

  \- Foreign Exchange Risk

  Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. As Zargon operates in North America, fluctuations in the exchange rate between the US/Canadian dollar can have a significant effect on the Company's reported results. A $0.01 change in the US to Canadian dollar exchange rate would have resulted in a $0.05 million (March 31, 2016 - $0.05 million) increase or decrease in net earnings for the period ended March 31, 2017. In order to mitigate the Company's exposure to foreign exchange fluctuations, the Company may enter into foreign exchange derivative agreements.

- Credit Risk

  Credit risk is the risk that the counterparty to a financial asset will default, resulting in the Company incurring a financial loss. This credit exposure is mitigated with credit practices that limit transactions according to counterparties' credit quality. A substantial portion of the Company's accounts receivable are with customers in the oil and natural gas industry and are subject to normal industry credit risks.

  The maximum credit risk exposure associated with accounts receivable and derivative assets is the total carrying value. The Company monitors these balances monthly to limit the risk associated with collection. Of Zargon's accounts receivable at March 31, 2017, approximately 82 percent (December 31, 2016 - 82 percent) was owing from two companies and Zargon anticipates full collection.

  The Company's allowance for doubtful accounts at March 31, 2017 was $0.09 million (December 31, 2016 - $0.11 million). During 2017, the Company did not record any additional provision for non-collectible accounts receivable.

  When determining whether amounts that are past due are collectible, management assesses the credit worthiness and past payment history of the counterparty, as well as the nature of the past due amount. Zargon considers all material amounts greater than 90 days to be past due. As at March 31, 2017, $0.09 million of accounts receivable are past due, excluding amounts described above, all of which are considered to be collectable.

- Liquidity Risk

  Liquidity risk is the risk the Company will encounter difficulties in meeting its financial liability obligations. The Company manages its liquidity risk through funds flow and debt management.

The timing of cash outflows relating to financial liabilities are outlined in the table below:

($ thousands)	1 year	2–4 years	Total
Trade and other payables	**7,786**	**–**	**7,786**
Derivative liabilities	**119**	**–**	**119**
Interest on convertible debentures	**3,355**	**5,883**	**9,238**
Convertible debentures (1)	**–**	**41,941**	**41,941**

(1) Amount is the full face value of the convertible debenture at $41.941 million.

Commodity Price Sensitivities

The following summarizes the sensitivity of the fair value of the Company's risk management positions to fluctuations in commodity prices, with all other variables held constant. When assessing the potential impact of these commodity price changes, the Company believes 10 percent volatility is a reasonable long term measure.

Fluctuations of 10 percent in commodity prices could have resulted in unrealized gains or losses of $1.79 million (March 31, 2016 – $0.23 million) for oil risk management contracts impacting net earnings for the three months ended March 31, 2017, respectively.

12. DERIVATIVE CONTRACTS

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production. The Company enters into these contracts for risk management purposes only in order to protect a portion of its future cash flows from the volatility of oil and natural gas commodity prices and interest rates. For financial risk management contracts, any unrealized gains or losses are recorded in earnings based on the fair value (mark-to-market) of the contracts at each reporting period. The unrealized gain on the statement of earnings/(loss) and comprehensive income/(loss) for the first three months of 2017 was $1.83 million and the unrealized loss for the first three months of 2016 was $0.93 million. The realized gain on the statement of earnings/(loss) and comprehensive income/(loss) for the first three months of 2017 was $0.03 million and the realized gain for the first three months of 2016 was $1.44 million.

As at March 31, 2017, the Company had the following outstanding commodity and interest risk management contracts:

Commodity Financial Risk Management Contracts:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Asset ($ thousands)
Oil swaps	350 bbl/d	$66.75 Cdn/bbl	Apr. 1/17 – Dec. 31/17	**(168)**
	300 bbl/d	$67.25 Cdn/bbl	Apr. 1/17 – Dec. 31/17	**(98)**
	650 bbl/d	$71.50 Cdn/bbl	Apr. 1/17 – Dec. 31/17	**629**
	1,300 bbl/d	WTI / WCS	Apr. 1/17 – Dec. 31/17	**(482)**
Total Fair Market Value, Commodity Price Financial Contracts				**(119)**

Oil swaps are settled against the NYMEX WTI pricing index.

On February 27, 2017, the company entered into a hedge to fix the differential between WTI and WCS (Western Canadian Select) at $19.50 Canadian dollars for the period April to December 2017.

13. SUBSEQUENT EVENT

As of April 1, 2017, changes to the debentures took effect, which were more particularly described in the Company's information circular dated January 16, 2017 (the "Information Circular") and as approved by the Debentureholders at a meeting held February 14, 2017. Debentures that were not tendered and were not redeemed pursuant to the Redemption Auction (the "amended debentures") now have an annual interest rate of eight percent.

The amended debentures were commenced trading on the Toronto Stock Exchange under the new symbol "ZAR.DB.A" at the open of markets on April 3, 2017. After giving effect to the Redemption Auction, there was approximately $41.94 million aggregate principal amount of the amended debentures outstanding.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Craig H. Hansen
Calgary, Alberta

K. James Harrison (2)
Chairman of the Board
Oakville, Ontario

Kyle D. Kitagawa (1)
Calgary, Alberta

Geoffrey C. Merritt (1)
Calgary, Alberta

Jim Peplinski (1) (2)
Calgary, Alberta

Ron Wigham (2)
Calgary, Alberta

Grant A. Zawalsky (2)
Calgary, Alberta

OFFICERS

Craig H. Hansen
President and Chief Executive Officer

Leslie E. Burden
Vice President, Land

Randolph J. Doetzel
Vice President, Operations

Christopher M. Hustad
Vice President, Development

William T. Cromb
Interim Chief Financial Officer

(1) Audit and Reserves Committee
(2) Governance and Compensation Committee

STOCK EXCHANGE LISTING

Toronto Stock Exchange

Common Shares
Trading Symbol: ZAR

Convertible Debentures
Trading Symbol: ZAR.DB.A

TRANSFER AGENT
Computershare Trust Company of Canada
100 University Avenue, 8th Floor
Toronto, Ontario M5J 2Y1

LEGAL COUNSEL
Burnet, Duckworth & Palmer LLP
2400, 525 – 8th Avenue S.W.
Calgary, Alberta T2P 1G1

CONSULTING ENGINEERS
McDaniel & Associates Consultants Ltd.
2200, 255 – 5th Avenue S.W.
Calgary, Alberta T2P 3G6

AUDITORS
Ernst & Young LLP
2200, 215 – 2nd Street S.W.
Calgary, Alberta T2P 1M4

HEAD OFFICE
700, 333 – 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: 403-264-9992
Fax: 403-265-3026
Email: zargon@zargon.ca

WEBSITE
www.zargon.ca