ZARGON OIL & GAS LTD.

# 2017 Q3 FINANCIAL REPORT

## FINANCIAL AND OPERATING HIGHLIGHTS

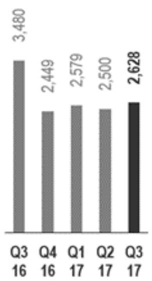
| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| (unaudited) | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| **Financial** | | | | | | |
| **Income and Investments** ($ millions) | | | | | | |
| Gross petroleum and natural gas sales | **9.28** | 12.33 | (25) | **28.37** | 35.47 | (20) |
| Funds flow from/(used in) operating activities | **1.76** | (0.51) | 445 | **4.40** | 2.66 | 65 |
| Cash flows from operating activities | **0.25** | 3.19 | (92) | **2.19** | 6.44 | (66) |
| Net earnings/(loss) | **(3.51)** | 11.73 | (130) | **(5.76)** | (2.36) | (144) |
| Net capital expenditures/(dispositions) | **1.77** | (90.29) | 102 | **6.41** | (86.56) | 107 |
| **Per Share, Basic** | | | | | | |
| Funds flow from/(used in) operating activities ($/share) | **0.06** | (0.02) | 400 | **0.14** | 0.09 | 56 |
| Cash flows from operating activities ($/share) | **0.01** | 0.10 | (90) | **0.07** | 0.21 | (67) |
| Net earnings/(loss) ($/share) | **(0.11)** | 0.38 | (129) | **(0.19)** | (0.08) | (138) |
| **Balance Sheet at Period End** ($ millions) | | | | | | |
| Property and equipment | | | | **131.46** | 151.98 | (14) |
| Exploration and evaluation assets | | | | **1.99** | 3.12 | (36) |
| Bank debt | | | | **–** | 30.00 | (100) |
| Convertible debentures at maturity | | | | **41.94** | 57.50 | (27) |
| Net debt | | | | **36.70** | 32.99 | 11 |
| Shareholders' equity | | | | **26.19** | 51.86 | (49) |
| **Total Common Shares Outstanding at Period End** (millions) | | | | **30.75** | 30.56 | 1 |
| **Operating** | | | | | | |
| **Average Daily Production** | | | | | | |
| Oil and liquids (bbl/d) | **2,037** | 2,915 | (30) | **1,991** | 3,275 | (39) |
| Natural gas (mmcf/d) | **3.55** | 3.39 | 5 | **3.47** | 3.67 | (5) |
| Equivalent (boe/d) | **2,628** | 3,480 | (24) | **2,569** | 3,887 | (34) |
| **Average Selling Price** (before the impact of financial risk management contracts) | | | | | | |
| Oil and liquids ($/bbl) | **47.17** | 43.41 | 9 | **48.50** | 37.67 | 29 |
| Natural gas ($/mcf) | **1.34** | 2.20 | (39) | **2.11** | 1.66 | 27 |
| **Wells Drilled, Net** | **–** | – | – | **–** | – | – |
| **Undeveloped Land at Period End** (thousand net acres) | | | | **36** | 48 | (25) |

*Throughout this report, the calculation of barrels of oil equivalent ("boe") is based on the conversion ratio that nine 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.*

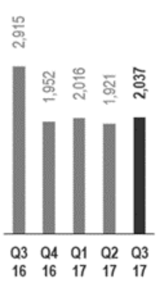
*Funds flow from operating activities is an additional GAAP term that represents net earnings/(loss) except for non-cash items. Funds flow from operating activities have been restated to exclude asset retirement expenditures. For a further discussion about this term, refer to the Management's Discussion 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 or $57.50 million (prior to March 31, 2017) and any working capital excluding unrealized assets/liabilities.*

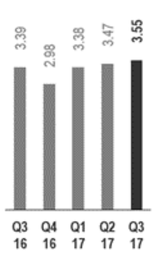
**Production**
*(boe/d)*




**Oil and Liquids Production**
*(bbl/d)*




**Natural Gas Production**
*(mmcf/d)*




## Message to Shareholders [1]

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

- Third quarter 2017 production averaged 2,628 barrels of oil equivalent per day, a five percent increase from the preceding quarter rate of 2,500 barrels of oil equivalent per day.
- Third quarter 2017 funds flow from operating activities of $1.76 million increased 54 percent from the $1.14 million recorded in the prior quarter.
- Third quarter 2017 operating (including transportation) costs of $20.17 per barrel of oil equivalent per day were ten percent less than the preceding quarter's costs of $22.49 per barrel of oil equivalent per day.
- Third quarter 2017 general and administrative costs of $3.68 per barrel of oil equivalent per day were 25 percent less than the preceding quarter's costs of $4.89 per barrel of oil equivalent per day.
- Third quarter 2017 capital expenditures were $1.77 million and were primarily allocated to oil exploitation costs relating to facility, waterflood implementation and well reactivation expenditures. These third quarter expenditures included $0.61 million of expenditures related to the Little Bow ASP project ($0.08 million exploitation and $0.53 million chemical costs). No wells were drilled in the quarter.
- For the remainder of 2017, Zargon is budgeting $1.89 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 the Little Bow non-ASP waterflood modifications and reactivations, Truro, North Dakota waterflood modifications, Bellshill Lake pumping oil well optimizations and Little Bow ASP project polymer costs. For further information regarding the potential and economics of these projects, please refer to our updated corporate presentation, which is available at www.zargon.ca.
- Third quarter 2017 abandonment and reclamation costs totaled $0.55 million. For the remainder of 2017, Zargon is budgeting $0.55 million of abandonment and reclamation expenditures.
- Zargon has initiated its 2018 hedging program and has entered into West Texas Intermediate ("WTI") hedges to fix the price on 1,000 barrels per day of oil production at an average price of $70.15 Canadian for the first quarter of 2018 and a WTI hedge to fix the price on 500 barrels per day of oil production at a price of $71.00 Canadian for the second quarter of 2018.

### 2017 Production Guidance [1]

In a December 12, 2016 capital budget press release, Zargon provided 2017 annual guidance levels of 2,500 barrels of oil equivalent per day. Zargon's year to date and third quarter 2017 production volumes have averaged 2,569 and 2,628 barrels of oil equivalent per day, respectively. Fourth quarter 2017 production volumes are expected to average 2,550 barrels of oil equivalent per day.

The 2017 production guidance levels have been consistently exceeded by virtue of a $8.30 million (projected) 2017 capital program focused on waterflood implementation and optimizations plus well reactivations / recompletions.

### H1 2018 Capital Budget [1]

Zargon's Board of Directors has approved a first half 2018 capital budget of $3.70 million. This budget is projected to deliver first half 2018 guidance levels of 2,600 barrels of oil equivalent per day (79 per cent oil and liquids), and is expected to be fully financed out of first half 2018 corporate funds flow at oil prices of $68.50 (Cdn.) per barrel (WTI) or better. Excluding hedges, Zargon estimates that its 2018 full year corporate funds flow will increase approximately $0.66 million for every $1 (Cdn.) per barrel (WTI) increase in oil price.

Similar to 2017, the first half 2018 capital budget will be directed to Little Bow non-ASP waterflood modifications and reactivations, North Dakota waterflood modifications, Bellshill Lake pumping oil well optimizations and Little Bow ASP project polymer costs. For further information regarding the potential and economics of these projects, please refer to our updated corporate presentation, which is available at www.zargon.ca.

### Strategic Alternatives Process Update [1]

In 2015 Zargon formed a Special Board Committee (the "Committee") to examine alternatives available to maximize shareholder value. Macquarie Capital Markets Canada Ltd. ("Macquarie") is currently engaged as Zargon's exclusive financial advisor. The Committee oversaw $92.04 million of property sales in 2016 and this year's partial repayment and amendment of Zargon's convertible debentures. The Company continues to evaluate strategic alternatives available to Zargon which 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 Board of Directors to be in the best interests of the Company and its stakeholders.

*(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 third quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three and nine months ended September 30, 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 nine 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 nine thousand cubic feet of gas. Boes and Mcfes may be misleading, particularly if used in isolation. A conversion ratio of one barrel to nine 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 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 November 13, 2017, and contains forward-looking statements including:*

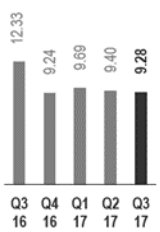
- *our expectations for our remaining 2017 capital budget program and the first half of 2018 capital budget program referred to under the headings "Message to Shareholders", "2017 Production Guidance" and "H1 2018 Capital Budget";*
- *our expectations for our 2017 abandonment and reclamation budget referred to under the heading "Message to Shareholders";*
- *our expectations for our fourth quarter 2017 and first half 2018 production referred to under the headings "2017 Production Guidance" and "H1 2018 Capital Budget";*
- *our strategic alternatives process referred to under the headings "Strategic Alternatives Process Update" and "Outlook";*
- *our expected sources of funds for capital expenditures referred to under the headings "H1 2018 Capital Budget" and "Liquidity and Capital Resources"; and*
- *our expectations for our 2018 hedges referred to under the heading "H1 2018 Capital Budget".*

*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.*

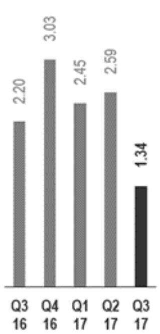
*You are cautioned that the assumptions, including among other things, future oil and natural gas prices; future capital expenditure levels (including ASP); future production levels; future exchange rates; the cost of developing and expanding our assets; our ability to obtain equipment in a timely manner 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 November 13, 2017.*

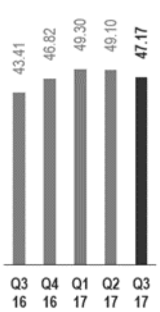
Petroleum and Natural Gas Revenue
*($ millions)*




Natural Gas Prices
*($/mcf)*




Oil and Liquids Prices
*($/bbl)*




# FINANCIAL & OPERATING RESULTS

## Petroleum and Natural Gas Sales

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| Petroleum sales | **8.84** | 11.64 | (24) | **26.37** | 33.80 | (22) |
| Natural gas sales | **0.44** | 0.69 | (36) | **2.00** | 1.67 | 20 |
| Petroleum and natural gas sales | **9.28** | 12.33 | (25) | **28.37** | 35.47 | (20) |

Third quarter 2017 gross petroleum and natural gas sales of $9.28 million were one percent below the $9.40 million in the preceding quarter and 25 percent below the $12.33 million in the third quarter of 2016. The year over year decrease is primarily due to reductions in oil and natural gas production volumes resulting from the third quarter 2016 property sales.

Third quarter 2017 realized oil and liquids field prices averaged $47.17 per barrel before the impact of financial risk management contracts and were four percent lower than the $49.10 per barrel recorded in the 2017 prior quarter. Zargon's crude oil field price differential from the Edmonton par price decreased to $9.45 per barrel in the third quarter of 2017 compared to $12.63 per barrel in the prior quarter of 2017. Natural gas field prices received averaged $1.34 per thousand cubic feet in the third quarter of 2017, a 48 percent decrease from the 2017 preceding quarter.

## Pricing

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| Average for the period | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| Natural Gas: | | | | | | |
| NYMEX average daily spot price ($US/mmbtu) | **2.93** | 2.85 | 3 | **2.99** | 2.31 | 29 |
| AECO average daily spot price ($Cdn/mmbtu) | **1.45** | 2.32 | (38) | **2.31** | 1.85 | 25 |
| Zargon realized field price before the impact of financial risk management contracts ($Cdn/mcf) | **1.34** | 2.20 | (39) | **2.11** | 1.66 | 27 |
| Zargon realized field price before the impact of physical and financial risk management contracts ($Cdn/mcf) | **1.34** | 2.20 | (39) | **2.13** | 1.66 | 28 |
| Zargon realized natural gas field price differential before the impact of physical and financial risk management contracts ($Cdn/mcf) | **0.11** | 0.12 | (8) | **0.18** | 0.19 | (5) |
| Crude Oil: | | | | | | |
| WTI ($US/bbl) | **48.21** | 44.94 | 7 | **49.47** | 41.33 | 20 |
| Edmonton par price ($Cdn/bbl) | **56.62** | 54.69 | 4 | **60.74** | 50.45 | 20 |
| Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl) | **47.17** | 43.41 | 9 | **48.50** | 37.67 | 29 |
| Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl) | **48.40** | 43.41 | 11 | **48.93** | 40.40 | 21 |
| Zargon realized oil field price differential [1] | **9.45** | 11.28 | (16) | **12.24** | 12.78 | (4) |

(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 third quarter were 2,037 barrels per day, a six percent increase from the preceding quarter rate of 1,921 barrels per day due to new production from our 2017 waterflood modification, reactivations and recompletion programs. This compares to a 30 percent decline from the 2016 third quarter rate of 2,915 barrels per day that included our Southeast Saskatchewan and Killam, Alberta assets that were sold in the third quarter of 2016. Natural gas production volumes in the 2017 third quarter of 3.55 million cubic feet per day were two percent higher than the 3.47 million cubic feet per day produced in the preceding quarter.

### Production by Core Area

| Three Months Ended September 30, | | **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 | **540** | **1.76** | **834** | 603 | 1.21 | 805 |
| Alberta Plains South | **1,099** | **1.79** | **1,396** | 1,184 | 1.95 | 1,509 |
| Williston Basin | **398** | **–** | **398** | 1,128 | 0.23 | 1,166 |
| | **2,037** | **3.55** | **2,628** | 2,915 | 3.39 | 3,480 |

| Nine Months Ended September 30, | | **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 | **540** | **1.72** | **827** | 655 | 1.44 | 895 |
| Alberta Plains South | **1,076** | **1.75** | **1,367** | 1,205 | 1.93 | 1,527 |
| Williston Basin | **375** | **–** | **375** | 1,415 | 0.30 | 1,465 |
| | **1,991** | **3.47** | **2,569** | 3,275 | 3.67 | 3,887 |

### 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 has entered into oil swaps fixing the WTI price on 1,300 barrels per day at an average price of $69.24 Canadian dollars for the balance of 2017. The company has also entered into a hedge to fix the differential between WTI and WCS (Western Canadian Select) at $19.50 Canadian dollars for the balance of 2017.

Subsequent to quarter end, Zargon entered into oil swaps fixing the WTI price on 1,000 barrels per day at an average of $70.15 Canadian dollars for the first quarter of 2018 and 500 barrels per day at $71.00 Canadian dollars for the second quarter of 2018.

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 third quarter, higher contract prices versus WTI oil prices offset by the WTI and WCS differential hedge resulted in a net realized gain on derivatives of $0.23 million compared to a $0.03 million net realized loss in the prior quarter of 2017 and a $0.04 million net realized loss in the third quarter of 2016.

The $1.06 million unrealized loss on derivatives in the third quarter of 2017 was related to oil contracts and compared to a $1.17 million gain in the prior quarter of 2017 and an interest rate swap gain of $0.04 million in the third 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 10 and 11 to the unaudited interim consolidated financial statements.

### Royalties

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| Royalties | **1.13** | 1.47 | (23) | **3.24** | 4.17 | (22) |
| Percentage of revenue | **12.2%** | 11.9% | | **11.4%** | 11.7% | |

Third quarter 2017 royalties of $1.13 million were essentially unchanged from the prior quarter of 2017 and decreased 23 percent from the 2016 third quarter primarily due to the properties sold in the third quarter of 2016. The variations in royalty rates generally track changes in production volumes and pricing. Third quarter of 2017 royalties were 12.2 percent of gross sales compared to 11.9 percent in the third quarter of 2016.

### Operating Expenses and Transportation Expenses

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| Operating expenses | **4.75** | 5.70 | (17) | **14.74** | 18.93 | (22) |
| Transportation expenses | **0.13** | 0.17 | (24) | **0.36** | 0.49 | (27) |
| Total expenses | **4.88** | 5.87 | (17) | **15.10** | 19.42 | (22) |
| Total expenses ($/boe) | **20.17** | 18.33 | 10 | **21.53** | 18.24 | 18 |

Third quarter 2017 operating expenses and transportation expenses of $4.88 million on a total dollar basis were down compared to $5.12 million recorded in the prior quarter of 2017 and reduced to $20.17 on a per barrel of oil equivalent basis compared to $22.49 in the previous quarter. Compared to the prior year's third quarter, operating expenses and transportation expenses in the 2016 third quarter were down on a total dollar basis due to the 2016 property sales. In contrast, costs were up on a per barrel of oil equivalent due to higher costs on remaining properties.

### Operating Netbacks

| Three Months Ended September 30, | **2017** | | 2016 | |
|---|---|---|---|---|
| | **Oil and Liquids ($/bbl)** | **Natural Gas ($/mcf)** | Oil and Liquids ($/bbl) | Natural Gas ($/mcf) |
| Sales | **47.17** | **1.34** | 43.41 | 2.20 |
| Royalties | **(5.89)** | **(0.09)** | (4.75) | (0.64) |
| Realized gain/(loss) on derivatives | **1.23** | **–** | – | – |
| Operating expenses | **(21.21)** | **(2.38)** | (17.97) | (2.81) |
| Transportation expenses | **(0.67)** | **–** | (0.64) | – |
| Operating netbacks | **20.63** | **(1.13)** | 20.05 | (1.25) |

| Nine Months Ended September 30, | **2017** | | 2016 | |
|---|---|---|---|---|
| | **Oil and Liquids ($/bbl)** | **Natural Gas ($/mcf)** | Oil and Liquids ($/bbl) | Natural Gas ($/mcf) |
| Sales | **48.50** | **2.11** | 37.67 | 1.66 |
| Royalties | **(5.72)** | **(0.14)** | (4.51) | (0.12) |
| Realized gain on derivatives | **0.43** | **–** | 2.73 | – |
| Operating expenses | **(22.49)** | **(2.66)** | (18.19) | (2.60) |
| Transportation expenses | **(0.66)** | **–** | (0.54) | – |
| Operating netbacks | **20.06** | **(0.69)** | 17.16 | (1.06) |

### General & Administrative ("G&A") Expenses

| | **Three Months Ended September 30,** | | | **Nine Months Ended September 30,** | | |
|---|---|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | Percent Change | **2017** | 2016 | Percent Change |
| G&A expenses | **0.89** | 3.22 | (72) | **3.16** | 6.29 | (50) |
| G&A expenses ($/boe) | **3.68** | 10.04 | (63) | **4.51** | 5.91 | (24) |

G&A expenses of $0.89 million and $3.68 per barrel of oil equivalent in the third quarter of 2017 were lower than $1.11 million and $4.89 per barrel of oil equivalent in the prior quarter of 2017 on both a dollar and per barrel of oil equivalent basis due to a continued focus on G&A cost containment initiatives. G&A expenses were also lower on both a dollar and a per barrel of oil equivalent basis than the third quarter of 2016, which had included one-time employee severance costs.

### Transaction Costs

Transaction costs for the 2017 third quarter were $0.04 million compared to $0.06 million in the prior quarter of 2017 and $0.92 million in the third quarter of 2016 and relate to Zargon's ongoing strategic alternatives review.

### Interest and Financing Charges on Bank Debt

Interest and financing charges in the 2017 third quarter were nil, unchanged from the preceding quarter and compared to an interest and financing charge of $0.45 million in the third quarter of 2016. The fluctuations in interest and financing charges/income 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 eight percent (six percent prior to April 1, 2017), calculated on the gross proceeds of $41.94 million ($57.50 million prior to March 31, 2017). Interest on convertible debentures in the 2017 third quarter were $0.83 million compared to $0.84 million in the prior quarter of 2017 and $0.86 million in the third quarter of 2016. For more details, please refer to Note 7 of the interim consolidated financial statements.

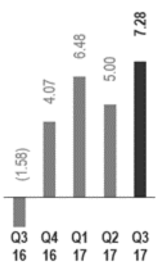
### Current Tax

The current tax recovery for the 2017 third quarter was $0.03 million compared to nil from both the preceding quarter and 2016 third quarter. Total corporate tax pools as at September 30, 2017 are approximately $192 million, essentially unchanged from the comparable $192 million of tax pools available to Zargon at December 31, 2016.

### Estimated Tax Pools

| ($ millions) | September 30, 2017 |
|---|---|
| Canadian oil and natural gas property expenses | – |
| Canadian development expenses | **7** |
| Canadian exploration expenses | **7** |
| Capital cost allowance | **27** |
| Non-capital losses | **148** |
| US tax pools | **1** |
| Other | **2** |
| Estimated tax pools | **192** |

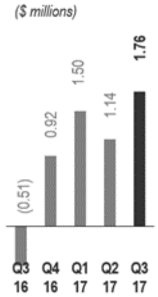
**Funds Flow Netbacks**
*($/boe)*




### Corporate Netbacks

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| ($/boe) | **2017** | 2016 | **2017** | 2016 |
| Petroleum and natural gas sales | **38.36** | 38.50 | **40.45** | 33.31 |
| Royalties | **(4.69)** | (4.60) | **(4.62)** | (3.91) |
| Realized gain/(loss) on derivatives | **0.95** | (0.13) | **0.33** | 2.12 |
| Operating expenses | **(19.65)** | (17.79) | **(21.02)** | (17.78) |
| Transportation expenses | **(0.52)** | (0.54) | **(0.51)** | (0.46) |
| Operating netbacks | **14.45** | 15.44 | **14.63** | 13.28 |
| General and administrative expenses | **(3.68)** | (10.04) | **(4.51)** | (5.91) |
| Transaction costs | **(0.18)** | (2.88) | **(0.30)** | (0.92) |
| Interest and financing charges | **0.01** | (1.40) | **0.02** | (1.67) |
| Interest on convertible debentures | **(3.44)** | (2.70) | **(3.61)** | (2.43) |
| Current tax recovery | **0.12** | – | **0.04** | 0.15 |
| Funds flow netbacks | **7.28** | (1.58) | **6.27** | 2.50 |

**Funds Flow from Operating Activities**
*($ millions)*




### Depletion and Depreciation Expense

Depletion and depreciation expense for the third quarter of 2017 decreased 14 percent to $3.48 million compared to $4.04 million in the third quarter of 2016. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $14.38 and $12.63 for the third quarter of 2017 and 2016, respectively. When compared to the third quarter of 2016, the increased depletion rate is primarily due to the property sales in the third quarter of 2016.

### Accretion of Asset Retirement Obligations and Convertible Debentures

The accretion expense of asset retirement obligations for the third quarter of 2017 was $0.37 million, a three percent decrease from the third quarter of 2016. 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 $41.94 million. Accretion on the convertible debenture for the 2017 third quarter is $0.05 million compared to $0.40 million in the 2016 third quarter.

#### Shared-based Compensation

Expensing of share-based compensation in the third quarter of 2017 totalled $0.12 million, which was higher than a recovery of $0.22 million incurred in the third quarter of 2016. The 2016 third quarter recovery related to forfeitures of shares awards pertaining to employee changes.

#### Unrealized Foreign Exchange

The Company had an unrealized foreign exchange loss of $0.03 million during the third quarter of 2017 compared to $0.02 million loss in the 2016 third 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 third quarter of $0.16 million compared to third quarter of 2016 expenses of $0.37 million. Exploration and evaluation expenses are primarily related to undeveloped land expiries. The 2017 third quarter exploration and evaluation expense related to expiries in North Dakota and Alberta.

#### Deferred Tax

The deferred tax expense for the third quarter of 2017 was $0.01 million compared to an expense of $18.11 million in the third quarter of 2016. The 2016 third quarter expense was related to derecognizing the deferred tax asset as a result of the sale of Southeast Saskatchewan properties.

#### Funds Flow from Operating Activities

Funds flow from operating activities in the 2017 third quarter of $1.76 million compared to $1.14 million in the 2017 second quarter, $1.50 million in the 2017 first quarter and negative funds flow of $0.51 million in the 2016 third quarter. Funds flow from operating activities has been restated to exclude asset retirement expenditures. The increase in funds flow compared to the 2017 second quarter was primarily a result of lower operating and transportation expenses, G&A expenses, and royalties offset by decreased oil and gas prices.

Details of the change in funds from operating activities during 2017 are as follows:

| **Three Months Ended** | | **2017** | |
|---|---|---|---|
| ($ millions) | **September 30** | June 30 | March 31 |
| **Funds flow from operating activities, previous quarter** | **1.14** | 1.50 | 0.92 |
| **Revenue and royalties:** | | | |
| Volume variance | **0.59** | (0.19) | 0.28 |
| Price variance | **(0.72)** | (0.09) | 0.17 |
| Royalties | **(0.02)** | (0.12) | 0.03 |
| Realized derivatives | **0.26** | (0.06) | 0.03 |
| **Expenses:** | | | |
| Operating and transportation | **0.24** | – | (0.24) |
| General and administrative | **0.22** | 0.05 | 0.17 |
| Transaction costs | **0.01** | 0.05 | 0.07 |
| Interest and financing | **0.01** | – | 0.05 |
| Current taxes | **0.03** | – | 0.02 |
| **Funds flow from operating activities, end of quarter** | **1.76** | 1.14 | 1.50 |

Compared to the fourth quarter of 2016, the Company has delivered small production gains in 2017 with the same property portfolio it has owned since the third quarter 2016 property dispositions. Funds flow from operating activities increased to $1.76 million in the third quarter of 2017 from $1.14 million generated in the second quarter of 2017 and $1.50 million from the first quarter of 2017. The increase reflects a gain on realized derivatives, lower operating and transportation expenses, and significantly lower G&A expenses, partially offset by lower revenue due to decreased production volumes.

**Net Earnings/(Loss)**

A net loss of $3.51 million for the 2017 third quarter was $15.24 million lower than $11.73 million of net earnings in the 2016 third quarter, largely due to a gain on disposal of assets in the third quarter of 2016. The net earnings/(loss) track the funds flow from operating activities for the respective periods modified by non-cash charges, which include depletion and depreciation, unrealized derivative gain/(loss), land expiries, accretion, property disposition gain/(loss) and deferred taxes. On a per diluted share basis, the third quarter 2017 net loss was $0.11, compared to a net earnings of $0.37 for the 2016 third quarter.

**Capital Expenditures**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | **2017** | 2016 |
| Undeveloped land | **0.39** | 0.49 | **1.29** | 1.40 |
| Geological and geophysical (seismic) | **0.03** | 0.02 | **0.21** | 0.19 |
| Drilling and completion of wells | **0.47** | 0.07 | **1.22** | (0.05) |
| Well equipment and facilities | **0.23** | (0.04) | **1.45** | (0.16) |
| ASP project and exploitation costs | **0.08** | 0.08 | **0.58** | 0.42 |
| ASP chemical costs | **0.53** | 1.28 | **1.42** | 3.84 |
| Exploration and development | **1.73** | 1.90 | **6.17** | 5.64 |
| Property acquisitions | **–** | (0.01) | **0.17** | 0.07 |
| Property dispositions | **–** | (92.04) | **–** | (92.13) |
| Net property acquisitions/(dispositions) | **–** | (92.05) | **0.17** | (92.06) |
| Total net capital expenditures excluding administrative assets | **1.73** | (90.15) | **6.34** | (86.42) |
| Administrative assets | **0.04** | (0.14) | **0.07** | (0.14) |
| Total net capital expenditures/(dispositions) | **1.77** | (90.29) | **6.41** | (86.56) |

## LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property dispositions) totalled $1.77 million in the third quarter of 2017 compared to net capital dispositions of $90.29 million in the same period in 2016. Field expenditures of $1.73 million for the third quarter of 2017 were nine percent lower than the 2016 third quarter. The third quarter 2017 field capital expenditures (excluding net property dispositions) were allocated to Alberta Plains North - $0.19 million, Alberta Plains South - $1.23 million and Williston Basin - $0.31 million and included the drilling of nil net wells, unchanged from the third quarter of 2016.

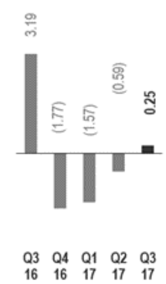
Included in the Alberta Plains South capital expenditures is the $0.61 million incurred on the Little Bow ASP project. Of the total ASP amount, $0.08 million was spent on project and exploitation costs while $0.53 million was spent on chemical costs for the facility.

Funds flow from operating activities in the 2017 third quarter of $1.76 million were used to fund the capital program.

At September 30, 2017, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $36.70 million, which compares to $33.51 million of net debt at the end of December 31, 2016. The $36.70 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.

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 eight percent, calculated on the gross proceeds of $41.94 million.

Cash Flows from Operating Activities
*($ millions)*




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.

For the quarter ended September 30, 2017, net capital expenditures totalled $1.77 million, which was $1.52 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $0.25 million. For the quarter ended September 30, 2016, net capital dispositions totalled $90.29 million, which was $93.48 million lower than the cash flows from operating activities (after changes in non-cash working capital) of $3.19 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 capital expenditures 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 November 13, 2017, Zargon had 30.75 million common shares outstanding. Pursuant to the stock option plan and the share award plan, there are currently an additional 0.41 million common share awards issued and outstanding and 1.25 million stock options issued and outstanding.

### Capital Sources and Uses

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| ($ millions) | **2017** | 2016 | **2017** | 2016 |
| Funds flow from operating activities | **1.76** | (0.51) | **4.40** | 2.66 |
| Change in long term bank debt | **–** | (35.08) | **–** | (30.24) |
| Change in cash | **1.53** | – | **18.95** | – |
| Change in convertible debenture | **–** | – | **(15.42)** | – |
| Asset retirement costs | **(0.55)** | (0.10) | **(1.25)** | (0.02) |
| Changes in working capital and other | **(0.97)** | (54.60) | **(0.27)** | (58.96) |
| Total capital sources | **1.77** | (90.29) | **6.41** | (86.56) |

## CONTRACTUAL OBLIGATIONS AND CONTINGENCIES

Zargon has certain contractual obligations relating to the lease of head office space, ASP related contracts and natural gas transportation sales contracts that extend for longer than one year as set out in the table below:

| ($ millions) | Total | 2017 | 2018 to 2019 | 2020 to 2021 | Thereafter |
|---|---|---|---|---|---|
| Head office lease and other | 0.32 | 0.13 | 0.19 | – | – |
| ASP related contracts | 0.13 | 0.03 | 0.10 | – | – |
| Total | 0.45 | 0.16 | 0.29 | – | – |

## LIABILITY MANAGEMENT RATING

On June 20, 2016, the Alberta Energy Regulator ("AER") issued Bulletin 2016-16 which put in place certain interim measures for transfers of AER regulated assets including a requirement that all transferees demonstrate that they have a Liability Management Rating ("LMR") of 2.0 or higher immediately following the transfer. At November 4, 2017, Zargon's LMR was 1.36. Although there is a significant level of uncertainty around the application of Bulletin 2016-16, it could restrict Zargon from buying or selling oil and gas assets, which could negatively impact its business.

## CHANGES IN ACCOUNTING POLICIES

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

## FUTURE CHANGES IN ACCOUNTING POLICIES

The Company's future changes in accounting policies are discussed in Note 3 to the Consolidated 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 third 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 formed a Special Board Committee (the "Committee") to examine alternatives available to maximize shareholder value. Macquarie Capital Markets Canada Ltd. ("Macquarie") is currently engaged as Zargon's exclusive financial advisor. The Committee oversaw $92.04 million of property sales in 2016 and this year's partial repayment and amendment of Zargon's convertible debentures. The Company continues to evaluate strategic alternatives available to Zargon which 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 Board of Directors to be in the best interests of the Company and its stakeholders.

## SUMMARY OF QUARTERLY RESULTS

| | | **2017** | |
|---|---|---|---|
| | Q1 | Q2 | **Q3** |
| Petroleum and natural gas sales ($ millions) | 9.69 | 9.40 | **9.28** |
| Net loss ($ millions) | (0.54) | (1.71) | **(3.51)** |
| Net loss per diluted share ($) | (0.02) | (0.06) | **(0.11)** |
| Funds flow from operating activities ($ millions) | 1.50 | 1.14 | **1.76** |
| Funds flow from operating activities per diluted share ($) | 0.05 | 0.04 | **0.06** |
| Cash flows from/(used in) operating activities ($ millions) | 2.53 | (0.59) | **0.25** |
| Cash flows from/(used in) operating activities per diluted share ($) | 0.08 | (0.02) | **0.01** |
| Net capital expenditures ($ millions) | 2.51 | 2.13 | **1.77** |
| Total assets ($ millions) | 153.75 | 150.11 | **144.76** |
| Convertible debentures ($ millions) (1) | 41.94 | 41.94 | **41.94** |
| Net debt | 35.09 | 36.06 | **36.70** |
| Average daily oil and liquids production (bbl) | 2,016 | 1,921 | **2,037** |
| Average daily natural gas production (mmcf) | 3.38 | 3.47 | **3.55** |
| Average daily production (boe) | 2,579 | 2,500 | **2,628** |
| Average oil production weighting (%) | 78 | 77 | **78** |
| Average realized commodity field price before the impact of financial risk management contracts ($/boe) | 41.74 | 41.34 | **38.36** |
| Funds flow netback ($/boe) | 6.48 | 5.00 | **7.28** |

*(1) Amount is full future face value of the convertible debentures.*

| | 2016 | | | |
|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 |
| Petroleum and natural gas sales ($ millions) | 9.61 | 13.53 | 12.33 | 9.24 |
| Net earnings/(loss) ($ millions) [(1)] | (8.82) | (5.27) | 11.73 | (17.82) |
| Net earnings/(loss) per diluted share ($) [(1)] | (0.29) | (0.17) | 0.38 | (0.58) |
| Funds flow from/(used in) operating activities ($ millions) [(2)] | (0.40) | 3.56 | (0.51) | 0.92 |
| Funds flow from/(used in) operating activities per diluted share ($) [(2)] | (0.01) | 0.12 | (0.01) | 0.03 |
| Cash flows from/(used in) operating activities ($ millions) | 2.07 | 1.18 | 3.19 | (1.77) |
| Cash flows from/(used in) operating activities per diluted share ($) | 0.07 | 0.04 | 0.12 | (0.06) |
| Net capital expenditures/(dispositions) ($ millions) | 2.47 | 1.26 | (90.29) | 1.43 |
| Total assets ($ millions) | 255.14 | 253.94 | 218.38 | 169.39 |
| Bank debt ($ millions) | 64.59 | 65.08 | 30.00 | – |
| Convertible debentures ($ millions) [(3)] | 57.50 | 57.50 | 57.50 | 57.50 |
| Net debt | 124.37 | 122.26 | 32.99 | 33.51 |
| Average daily oil and liquids production (bbl) | 3,503 | 3,413 | 2,915 | 1,952 |
| Average daily natural gas production (mmcf) | 4.04 | 3.58 | 3.39 | 2.98 |
| Average daily production (boe) | 4,176 | 4,010 | 3,480 | 2,449 |
| Average oil production weighting (%) | 84 | 85 | 84 | 80 |
| Average realized commodity field price before the impact of financial risk management contracts ($/boe) | 25.30 | 37.09 | 38.50 | 41.01 |
| Funds flow netback ($/boe) [(2)] | (1.05) | 9.77 | (1.58) | 4.07 |

*(1) Q3 2016 and Q4 2016 net loss and net loss per diluted share have been restated for deferred income tax expense.*

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

*(3) 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.*

| | 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) (1) | 8.73 | 10.26 | 3.65 | 3.94 |
| Funds flow from operating activities per diluted share ($)(1) | 0.29 | 0.34 | 0.12 | 0.13 |
| Cash flows from/(used in) operating activities ($ millions) | 6.67 | 6.98 | 7.65 | (1.05) |
| Cash flows from/(used in) operating activities per diluted share ($) | 0.22 | 0.23 | 0.25 | (0.03) |
| Cash dividends ($ millions) (3) | 2.72 | 2.73 | 0.91 | 0.30 |
| Cash dividends declared per common share ($) (3) | 0.09 | 0.09 | 0.03 | 0.01 |
| Net capital expenditures ($ millions) | 5.40 | 5.35 | 7.38 | 7.75 |
| Total assets ($ millions) | 377.16 | 369.47 | 325.64 | 263.66 |
| 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) (1) | 20.19 | 24.48 | 8.80 | 9.85 |

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

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

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
November 13, 2017

# CONSOLIDATED BALANCE SHEETS

| (unaudited) | | | Restated - Note 13 |
|---|---|---|---|
| ($ thousands) | Notes | **September 30, 2017** | December 31, 2016 |
| **ASSETS** | | | |
| Cash and cash equivalents | | **5,905** | 23,919 |
| Restricted cash | | **–** | 936 |
| Trade and other receivables | 10 | **3,639** | 3,485 |
| Deposits and prepaid expenses | | **1,735** | 836 |
| Investment in marketable securities | 10 | **–** | 185 |
| Total current assets | | **11,279** | 29,361 |
| Long term deposits | | **26** | 328 |
| Property, plant and equipment, net | 4 | **131,463** | 137,479 |
| Intangible exploration and evaluation assets | 5 | **1,987** | 2,226 |
| Total assets | | **144,755** | 169,394 |
| **LIABILITIES** | | | |
| Trade and other payables | 10 | **6,041** | 5,366 |
| Convertible debentures | 7,10 | **–** | 56,671 |
| Derivatives | 10,11 | **8** | 1,948 |
| Total current liabilities | | **6,049** | 63,985 |
| Convertible debentures | 7,10 | **41,407** | – |
| Asset retirement obligations | 6 | **65,324** | 66,749 |
| Deferred tax liabilities | 13 | **5,787** | 6,435 |
| Total liabilities | | **118,567** | 137,169 |
| Commitments and contingencies | 6,12 | | |
| **EQUITY** | | | |
| Shareholders' capital | 8 | **261,943** | 260,902 |
| Accumulated other comprehensive income | 13 | **4,448** | 4,902 |
| Contributed surplus | 9 | **9,819** | 10,614 |
| Equity component of debentures | 7 | **3,570** | 3,640 |
| Deficit | 13 | **(253,592)** | (247,833) |
| Total equity | 13 | **26,188** | 32,225 |
| Total equity and liabilities | | **144,755** | 169,394 |

*See accompanying notes to the interim consolidated financial statements.*

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

| (unaudited) | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|---|
| | | | Restated - Note 13 | | Restated - Note 13 |
| ($ thousands, except per share amounts) | Notes | **2017** | 2016 | **2017** | 2016 |
| Petroleum and natural gas sales | | **9,275** | 12,327 | **28,368** | 35,474 |
| Royalties | | **(1,133)** | (1,473) | **(3,241)** | (4,166) |
| **PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES** | | **8,142** | 10,854 | **25,127** | 31,308 |
| (Loss)/gain on unrealized derivatives | 10,11 | **(1,059)** | 40 | **1,940** | (2,121) |
| Gain/(loss) on realized derivatives | 10,11 | **229** | (41) | **232** | 2,253 |
| **GAIN/(LOSS) ON DERIVATIVES** | | **(830)** | (1) | **2,172** | 132 |
| **TOTAL INCOME** | | **7,312** | 10,853 | **27,299** | 31,440 |
| Operating | | **4,752** | 5,695 | **14,743** | 18,935 |
| Transportation | | **125** | 173 | **360** | 487 |
| General and administrative | | **890** | 3,215 | **3,160** | 6,294 |
| Transaction costs | | **43** | 923 | **209** | 976 |
| Exploration and evaluation | 5 | **157** | 372 | **360** | 591 |
| Gain on convertible debentures | 7 | **–** | – | **(458)** | – |
| Gain on disposal of properties | 4 | **–** | (35,288) | **(4)** | (35,430) |
| Share-based compensation | 9 | **117** | (217) | **246** | 86 |
| Unrealized foreign exchange loss | | **30** | 17 | **86** | 652 |
| Loss on sale of marketable securities | | **–** | – | **–** | 215 |
| Impairment loss on marketable securities | | **–** | – | **185** | – |
| Depletion and depreciation | 4 | **3,476** | 4,043 | **10,237** | 16,481 |
| **EXPENSES/(RECOVERY)** | | **9,590** | (21,067) | **29,124** | 9,287 |
| **(LOSS)/EARNINGS BEFORE FINANCE EXPENSES AND INCOME TAXES** | | **(2,278)** | 31,920 | **(1,825)** | 22,153 |
| Interest and financing charges | | **(1)** | 448 | **(15)** | 1,778 |
| Interest on convertible debentures | 7 | **833** | 863 | **2,533** | 2,588 |
| Accretion on convertible debentures | 7 | **52** | 399 | **541** | 1,143 |
| Accretion of asset retirement obligations | 6 | **366** | 376 | **1,109** | 1,349 |
| **FINANCE EXPENSES** | | **1,250** | 2,086 | **4,168** | 6,858 |
| **(LOSS)/EARNINGS BEFORE INCOME TAXES** | | **(3,528)** | 29,834 | **(5,993)** | 15,295 |
| Current tax (recovery)/expense | | **(30)** | 1 | **(30)** | (159) |
| Deferred tax expense/(recovery) | 13 | **7** | 18,105 | **(204)** | 17,818 |
| **INCOME TAXES (RECOVERY)/EXPENSE** | 13 | **(23)** | 18,106 | **(234)** | 17,659 |
| **NET (LOSS)/EARNINGS FOR THE PERIOD** | 13 | **(3,505)** | 11,728 | **(5,759)** | (2,364) |
| Currency translation adjustment recognized in other comprehensive income | 13 | **(237)** | 90 | **(454)** | (518) |
| **OTHER COMPREHENSIVE (LOSS)/EARNINGS FOR THE PERIOD** | 13 | **(237)** | 90 | **(454)** | (518) |
| **TOTAL COMPREHENSIVE (LOSS)/EARNINGS FOR THE PERIOD** | 13 | **(3,742)** | 11,818 | **(6,213)** | (2,882) |
| **NET (LOSS)/EARNINGS PER SHARE** | | | | | |
| Basic | 13 | **(0.11)** | 0.38 | **(0.19)** | (0.08) |
| Diluted | 13 | **(0.11)** | 0.37 | **(0.19)** | (0.08) |

*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** | 13 | **260,902** | **4,902** | **10,614** | **3,640** | **(247,833)** | **32,225** |
| Net loss for the period | | **–** | **–** | **–** | **–** | **(5,759)** | **(5,759)** |
| Share-based compensation | 9 | **–** | **–** | **246** | **–** | **–** | **246** |
| Exercise of share awards | 8 | **1,041** | **–** | **(1,041)** | **–** | **–** | **–** |
| Equity component of convertible debentures | | **–** | **–** | **–** | **(70)** | **–** | **(70)** |
| Translation differences on foreign subsidiary | | **–** | **(454)** | **–** | **–** | **–** | **(454)** |
| **Balance at September 30, 2017** | | **261,943** | **4,448** | **9,819** | **3,570** | **(253,592)** | **26,188** |
| | | | | | | | |
| **Balance at December 31, 2015** | | 259,149 | 5,249 | 12,198 | 3,640 | (227,655) | 52,581 |
| Net loss for the period | 13 | – | – | – | – | (2,364) | (2,364) |
| Share-based compensation | 9 | – | – | 86 | – | – | 86 |
| Exercise of share awards | 8 | 1,470 | – | (1,470) | – | – | – |
| Translation differences on foreign subsidiary | 13 | – | (518) | – | – | – | (518) |
| **Balance at September 30, 2016** Restated - Note 13 | 13 | 260,619 | 4,731 | 10,814 | 3,640 | (230,019) | 49,785 |

*See accompanying notes to the interim consolidated financial statements.*

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| (unaudited) | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|---|
| | | | Restated - Note 13 | | Restated - Note 13 |
| ($ thousands) | Notes | **2017** | 2016 | **2017** | 2016 |
| **OPERATING ACTIVITIES** | | | | | |
| Net (loss)/earnings for the period | 13 | **(3,505)** | 11,728 | **(5,759)** | (2,364) |
| Adjustments for non-cash items: | | | | | |
| Gain on convertible debentures | 7 | **–** | – | **(458)** | – |
| Gain on sale of properties | 4 | | (35,288) | **(4)** | (35,430) |
| Loss/(gain) on unrealized derivatives | 10,11 | **1,059** | (40) | **(1,940)** | 2,121 |
| Depletion and depreciation | 4 | **3,476** | 4,043 | **10,237** | 16,481 |
| Accretion of asset retirement obligations | 6 | **366** | 376 | **1,109** | 1,349 |
| Accretion of convertible debentures | 7 | **52** | 399 | **541** | 1,143 |
| Share-based compensation | 9 | **117** | (217) | **246** | 86 |
| Unrealized foreign exchange loss | | **30** | 17 | **86** | 652 |
| Loss on sale of marketable securities | | **–** | – | **–** | 215 |
| Impairment loss on marketable securities | | **–** | – | **185** | – |
| Deferred tax expense/(recovery) | 13 | **7** | 18,105 | **(204)** | 17,818 |
| Exploration and evaluation expenses | 5 | **157** | 372 | **360** | 591 |
| Funds flow from/(used in) operating activities | | **1,759** | (505) | **4,399** | 2,662 |
| Asset retirement expenditures | 6 | **(554)** | (104) | **(1,248)** | (21) |
| Changes in operating working capital | | **(956)** | 3,794 | **(963)** | 3,795 |
| Net cash from operating activities | | **249** | 3,185 | **2,188** | 6,436 |
| **INVESTING ACTIVITIES** | | | | | |
| Additions to property, plant and equipment | 4 | **(1,766)** | (3,757) | **(6,271)** | (7,515) |
| Additions to intangible exploration and evaluation assets | 5 | **(3)** | (18) | **(140)** | (113) |
| Proceeds on disposal of property, plant and equipment | | **–** | 92,046 | **–** | 92,133 |
| Proceeds on disposal of intangible exploration and evaluation assets | | **–** | 2,019 | **–** | 2,054 |
| Change in restricted cash | | **–** | (30,928) | **936** | (30,928) |
| Change in long term deposits | | **–** | (302) | **302** | (161) |
| Changes in investing working capital | | **(8)** | 489 | **388** | (4,018) |
| Net cash used in investing activities | | **(1,777)** | 59,549 | **(4,785)** | 51,452 |
| **FINANCING ACTIVITIES** | | | | | |
| Repayment of bank debt | | **–** | (35,084) | **–** | (30,238) |
| Redemption of convertible debentures, including transaction costs | 7 | **–** | – | **(15,417)** | – |
| Net cash (used in)/provided by financing activities | | **–** | (35,084) | **(15,417)** | (30,238) |
| NET CHANGE IN CASH DURING THE PERIOD | | **(1,528)** | 27,650 | **(18,014)** | 27,650 |
| CASH, BEGINNING OF PERIOD | | **7,433** | – | **23,919** | – |
| CASH, END OF PERIOD | | **5,905** | 27,650 | **5,905** | 27,650 |

*See accompanying notes to the interim consolidated financial statements.*

*For the three and nine months ended September 30, 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 September 30, 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 and nine month periods ended September 30, 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 and nine month periods ended September 30, 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 November 13, 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 is currently evaluating the impact of adopting IFRS 9 on its 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 is currently assessing the impact of adopting IFRS 15, however, it anticipates that this standard will not have a material impact on the Company’s consolidated financial statements.
- IFRS 16 “Leases”, was issued by the 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”. IFRS 16 will be applied by Zargon on January 1, 2019 and the Company is currently evaluating the impact of the standard on the Company’s consolidated financial statements.

## 4. 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 | **6,271** |
| Change in asset retirement obligation | **(751)** |
| Exchange differences | **(1,322)** |
| Depletion and depreciation | **(10,237)** |
| Other | **23** |
| Net carrying amount, September 30, 2017 | **131,463** |
| Cost, September 30, 2017 | **294,521** |
| Accumulated depletion and depreciation | **(163,058)** |
| Net carrying amount, September 30, 2017 | **131,463** |

## 5. INTANGIBLE EXPLORATION AND EVALUATION ASSETS

($ thousands)

| | |
|---|---|
| Cost, Balance at December 31, 2016 | **2,226** |
| Additions | **140** |
| Exploration and evaluation expense | **(360)** |
| Exchange differences | **(19)** |
| Balance at September 30, 2017 | **1,987** |

## 6. ASSET RETIREMENT OBLIGATIONS

($ thousands)

| | |
|---|---|
| Balance at December 31, 2016 | **66,749** |
| Foreign exchange and other | **(535)** |
| Asset retirement expenditures | **(1,248)** |
| Revisions to estimated asset retirement obligations | **(751)** |
| Accretion | **1,109** |
| Balance at September 30, 2017 | **65,324** |

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.

## 7. 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 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) | **September 30, 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 | **(14,842)** | – |
| Gain on convertible debenture | **(458)** | – |
| Transaction costs | **(505)** | – |
| Accretion of convertible debentures | **541** | 1,542 |
| Debt component, end of period | **41,407** | 56,671 |
| Equity component, beginning of year | **3,640** | 3,640 |
| Transaction costs | **(70)** | – |
| Equity component, end of period | **3,570** | 3,640 |

## 8. SHARE CAPITAL

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

### Common Shares

| | **Nine Months Ended September 30, 2017** | |
|---|---|---|
| (thousands) | **Number of Shares** | **Amount ($)** |
| Balance, as at December 31, 2016 | **30,607** | **260,902** |
| Share awards exercised | **140** | **–** |
| Share-based compensation recognized on exercise of share awards | **–** | **1,041** |
| Balance, as at September 30, 2017 | **30,747** | **261,943** |

## 9. 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.

On May 30, 2017, the 2017 stock option plan was approved by a majority of the aggregate votes casted by shareholders at the 2017 Annual and Special General Meeting.

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

| | Nine Months Ended September 30, 2017 |
|---|---|
| | **Number of Stock Options (thousands)** |
| Outstanding, as at December 31, 2016 | **–** |
| Stock options granted | **1,340** |
| Stock options forfeited | **(90)** |
| Outstanding, as at September 30, 2017 | **1,250** |

**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 16 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:

| | Nine Months Ended September 30, 2017 |
|---|---|
| | **Number of Share Awards (thousands)** |
| Outstanding, as at December 31, 2016 | **544** |
| Share awards granted | **29** |
| Share awards exercised | **(140)** |
| Share awards forfeited | **(25)** |
| Outstanding, as at September 30, 2017 | **408** |

**Share-based Compensation**

The share awards for the three and nine months ended September 30, 2017, resulted in a share-based compensation of $0.12 million (2016 - $0.22 million recovery) and $0.25 million (2016 - $0.09 million), respectively.

Compensation expense associated with share awards granted is recognized in earnings over the vesting period with a corresponding increase in contributed surplus. The exercise of 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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (thousands of shares) | **2017** | 2016 | **2017** | 2016 |
| Weighted average number of common shares – basic | **30,747** | 30,496 | **30,714** | 30,469 |
| Weighted average number of common shares – diluted | **30,747** | 33,830 | **30,714** | 30,469 |

No dilution amounts for the three and nine months ended September 30, 2017 (2016 - 0.28 million shares) and nil shares (2016 – nil shares), respectively, were added to the weighted average number of shares outstanding during the period in the calculation of diluted per share amounts.

Dilution amounts for the three and nine months ended September 30, 2017 of nil shares (2016 – 3.06 million shares) and nil shares (2016 – nil shares) 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 the convertible debentures.

### 10. 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:

| | **September 30, 2017** | | December 31, 2016 | |
|---|---|---|---|---|
| **($ thousands)** | **Carrying Value** | **Fair Value** | Carrying Value | Fair Value |
| **Loans and receivables:** | | | | |
| Trade and other receivables | **3,639** | **3,639** | 3,485 | 3,485 |
| **Fair value through profit and loss:** | | | | |
| Derivative assets | **–** | **–** | – | – |
| Derivative liabilities | **8** | **8** | 1,948 | 1,948 |
| **Fair value through other comprehensive income:** | | | | |
| Investment in marketable securities | **–** | **–** | 185 | 185 |
| **Other liabilities:** | | | | |
| Trade and other payables | **6,041** | **6,041** | 5,366 | 5,366 |
| Convertible debentures | **41,407** | **34,832** | 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 fair value measurements 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 September 30, 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 may enter 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 and to the basis differential between WTI and WCS at $19.50 Canadian dollars for the period October to December 2017.

  - 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 $0.14 million (September 30, 2016 - $0.19 million) increase or decrease in net earnings for the period ended September 30, 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 September 30, 2017, approximately 81 percent (December 31, 2016 - 82 percent) was owing from two companies and Zargon anticipates full collection.

  The Company's allowance for doubtful accounts at September 30, 2017 was $0.04 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 September 30, 2017, $0.04 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 | **6,041** | **–** | **6,041** |
| Derivative liabilities | **8** | **–** | **8** |
| Interest on convertible debentures | **3,355** | **846** | **4,201** |
| 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 $0.60 million (September 30, 2016 – nil) for oil risk management contracts impacting net earnings for the nine months ended September 30, 2017.

## 11. DERIVATIVE CONTRACTS

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production and interest rates. 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 or loss on the consolidated statement of earnings/(loss) and comprehensive earnings/(loss) for the three and nine month periods of 2017 was $1.06 million loss (2016 - $0.04 million gain) and $1.94 million gain (2016 - $2.12 million loss), respectively. The realized gain or loss on the consolidated statement of earnings/(loss) and comprehensive earnings/(loss) for the three and nine month periods of 2017 was $0.23 million gain (2016 - $0.04 million loss) and $0.23 million gain (2016 - $2.25 million gain), respectively.

As at September 30, 2017, the Company had the following outstanding commodity risk management contracts:

### Commodity Financial Risk Management Contracts:

| | Rate | Weighted Average Price | Range of Terms | Fair Market Value Liability ($ thousands) |
|---|---|---|---|---|
| Oil swaps | 350 bbl/d | $66.75 Cdn/bbl | Oct. 1/17 – Dec. 31/17 | **121** |
| | 300 bbl/d | $67.25 Cdn/bbl | Oct. 1/17 – Dec. 31/17 | **119** |
| | 650 bbl/d | $71.50 Cdn/bbl | Oct. 1/17 – Dec. 31/17 | **597** |
| | 1,300 bbl/d | $19.50 Cdn WTI/WCS differential | Oct. 1/17 – Dec. 31/17 | **(845)** |
| Total Fair Market Value, Commodity Price Financial Contracts | | | | **(8)** |

Oil swaps are settled against the NYMEX WTI pricing index.

## 12. COMMITMENTS AND CONTINGENCIES

In the normal course of operations, Zargon executes agreements that provide for indemnification and guarantees to counterparties in transactions such as the sale of assets and operating leases.

These indemnifications and guarantees may require compensation to counterparties for costs and losses incurred as a result of various events, including breaches of representations and warranties, loss of or damages to property, environmental liabilities or as a result of litigation that may be suffered by counterparties.

Certain indemnifications can extend for an unlimited period and generally do not provide for any limit on the maximum potential amount. The nature of substantially all of the indemnifications prevents the Company from making a reasonable estimate of the maximum potential amount that might be required to pay counterparties as the agreements do not specify a maximum amount, and the amounts depend on the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their services to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers. The Company is party to various legal claims associated with the ordinary conduct of business. The Company does not anticipate that these claims will have a material impact on its financial position.

The Company is committed to future minimum payments for natural gas transportation sales commitments, Alkaline Surfactant Polymer purchase commitments and operating leases for office space and office equipment. Payments required under these commitments are as follows:

| ($ thousands) | September 30, 2017 |
|---|---|
| Less than one year | **0.16** |
| Between one and five years | **0.29** |
| | **0.45** |

## 13. RESTATEMENT OF PRIOR PERIOD

It was identified that there was an error in the allocation of the property, plant and equipment between the Canadian and US business segments in the prior year in the calculation of deferred taxes which resulted in an understatement of the deferred tax liabilities related to the US business segment of $2.12 million. As such, the Company has retrospectively restated its 2016 previously reported consolidated financial statements commencing in the 2017 second quarter.

Certain 2016 balances have been restated due to a recalculation of deferred tax balances. Deferred tax liabilities have been increased by $2.12 million, accumulated other comprehensive income has been decreased by $0.03 million, and deficit has been increased by $2.09 million from amounts previously reported as at September 30, 2016 and December 31, 2016. The retrospective restatement to correct for this error has decreased net earnings by $2.09 million for the period ended September 30, 2016 on the comparative income statement and statement of cash flows presented within these interim unaudited consolidated financial statements.

## 14. SUBSEQUENT EVENT

On November 3, 2017, the Company entered into an oil swap fixing the WTI price on 500 barrels per day at $69.00 in Canadian dollars per day for the first quarter of 2018.

On November 6, 2017, the Company entered into an oil swap fixing the WTI price on 500 barrels per day at $71.00 in Canadian dollars per day for the second quarter of 2018.

On November 13, 2017, the Company entered into an oil swap fixing the WTI price on 500 barrels per day at $71.30 in Canadian dollars per day for the first quarter of 2018.

# CORPORATE INFORMATION

**BOARD OF DIRECTORS**

Craig H. Hansen
*Calgary, Alberta*

Kyle D. Kitagawa (1)
*Chairman of the Board*
*Calgary, Alberta*

Geoffrey C. Merritt (1)
*Calgary, Alberta*

Jim Peplinski (2)
*Calgary, Alberta*

Ron Wigham (1) (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**

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