ZARGON OIL & GAS LTD.

2018 Q1 FINANCIAL REPORT

FINANCIAL AND OPERATING HIGHLIGHTS

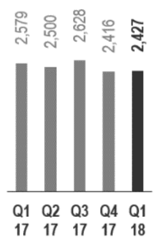
(unaudited)	Three Months Ended March 31, 2018	2017	Percent Change
Financial			
Income and Investments ($ millions)			
Petroleum and natural gas sales	**9.71**	9.69	–
Funds flow from/(used in) operating activities	**(0.30)**	1.50	(120)
Cash flows from operating activities	**0.80**	2.52	(68)
Net loss	**(4.33)**	(0.54)	(702)
Net capital expenditures	**1.50**	2.51	(40)
Per Share, Basic			
Funds flow from/(used in) operating activities ($/share)	**(0.01)**	0.05	(120)
Cash flows from operating activities ($/share)	**0.03**	0.08	(63)
Net loss ($/share)	**(0.14)**	(0.02)	(600)
Balance Sheet at Period End ($ millions)			
Property, plant and equipment	**126.89**	136.09	(7)
Exploration and evaluation assets	**1.79**	2.30	(22)
Total assets	**136.83**	153.75	(11)
Convertible debentures at maturity	**41.94**	41.94	–
Net debt	**40.79**	35.09	16
Shareholders' equity	**19.16**	31.59	(39)
Total Common Shares Outstanding at Period End (millions)	**30.86**	30.72	–
Operating			
Average Daily Production			
Oil and liquids (bbl/d)	**1,949**	2,016	(3)
Natural gas (mmcf/d)	**2.87**	3.38	(15)
Equivalent (boe/d)	**2,427**	2,579	(6)
Average Selling Price (before the impact of financial risk management contracts)			
Oil and liquids ($/bbl)	**52.48**	49.30	6
Natural gas ($/mcf)	**1.98**	2.45	(19)
Undeveloped Land at Period End (thousand net acres)	**33**	40	(18)

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

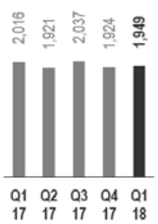
Funds flow from operating activities is an additional GAAP term that represents net earnings/(loss) except for non-cash items. Funds flow from operating activities have been restated to exclude asset retirement expenditures. For a further discussion about this term, refer to the Management's Discussion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

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

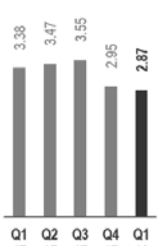
Production
(boe/d)



Oil and Liquids Production
(bbl/d)



Natural Gas Production
(mmcf/d)



Message to Shareholders (1) (2)

Zargon Oil & Gas Ltd. has released financial and operating results for the first quarter of 2018. Specific financial and operating highlights in the first quarter of 2018 include:

- Funds flow from operating activities of a negative $0.30 million compare to the positive $1.59 million recorded in the prior quarter, and the positive $1.50 million reported in first quarter of 2017. The reduction in funds flow is primarily due to Zargon’s first quarter 2018 realized hedging losses of $0.85 million and higher one-time operating and transportation costs.
- First quarter 2018 production averaged 2,427 barrels of oil equivalent per day essentially unchanged from 2,416 barrels of oil equivalent per pay in the prior quarter and a six percent decrease from the 2017 first quarter rate of 2,579 barrels of oil equivalent per day.
- First quarter 2018 capital expenditures totaled $1.50 million, a $0.95 million decrease from the $2.45 million recorded in the prior quarter. The cash constrained reduced program was primarily allocated to reactivations and waterflood optimizations. No wells were drilled in the quarter.
- First quarter 2018 abandonment and reclamation costs totaled $0.61 million, a $0.26 million decrease from the $0.87 million recorded in the prior quarter.

Discussion (1)

Zargon’s first quarter results reflected the following challenges:

- WTI oil hedge losses: For the first half of 2018, Zargon has hedged 1,000 barrels of oil per day at an average WTI oil price of $70.33 Canadian dollar per barrel. WTI oil prices averaged $79.51 Canadian dollar per barrel in the first quarter and are currently exceeding $88 Canadian dollar per barrel. Although Zargon’s first quarter realized hedge loss was $0.85 million, we did not receive an offsetting benefit in our field prices received due to the large increase in WTI-WCS differentials.
- WTI-WCS differentials: Zargon’s realized field prices for our Alberta properties tracks closely (small premium) to the posted WCS prices. For the 2018 first quarter, the WTI-WCS differential averaged $30.76 Canadian dollar per barrel, almost double the actual 2017 WTI-WCS differential of $15.57 Canadian dollar per barrel. This field price reduction was not protected by our WTI hedges and resulted in a significant decrease in field revenues. Although April 2018 differentials have remained elevated, the May 2018 differentials have improved dramatically and have returned to the $21.50 Canadian dollar per barrel level.
- Operating Costs: The first quarter operating costs were elevated due to a combination of workover expenditures (non-capitalized) on a set of challenging reactivations, higher electricity costs and cold weather related operational costs. Looking forward, we expect to return to our historical operating costs for the remainder of the year.
- Natural gas economics and shut-ins: This summer’s Alberta natural gas pricing outlook remains challenging, and we have proactively shut-in our uneconomic natural gas properties. For the 2018 second half, we are now forecasting an average natural gas rate of 1.91 million cubic feet per day.
- Capital programs: With the sharp reduction in first quarter cash flows, we have deferred spending on our discretionary oil exploitation capital programs until the third quarter of this year, when our WTI oil hedges will have expired and the current forward curve for WTI prices and WTI-WCS differentials are predicting a 26 percent improvement in our average field price from first quarter levels. These capital deferrals are having an impact on our oil production and for the 2018 second half, we are now forecasting an average oil and liquids rate of 1,830 barrels of oil per day.

Fortunately, the outlook for Zargon is improving dramatically with the recent ramp up in WTI oil prices, the June 30 expiry of our “out of the money” hedges, the May 2018 improvement of the WTI-WCS differentials, the return to base level operating costs for the remainder of the year and the resumption of our oil exploitation capital programs in the second half of this year. For further information regarding Zargon’s properties, opportunities and outlook, please refer to our updated corporate presentation, which is available at www.zargon.ca.

Strategic Alternatives Process Update [1]

Zargon’s Board of Directors recognizes that Zargon is a suboptimal size to operate as a public oil and gas Company in Canada, and continues to explore alternatives to allow Zargon to continue as part of a larger, better capitalized entity. The Board also recognizes, that Zargon’s long-life, low-decline oil exploitation assets have significant upside potential in a period of prolonged higher oil prices. In addition to this option value to higher oil prices, Zargon brings a TSX listing and more than $150 million of non-capital losses that could have significant value in a more favourable Canadian energy investment climate.

In an effort to realize these unrecognized values, Zargon has previously initiated a strategic alternatives process and continues to seek outcomes that will maximize the value for the Company and its stakeholders.

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

MANAGEMENT’S DISCUSSION AND ANALYSIS

Management’s discussion and analysis (“MD&A”) is a review of Zargon Oil & Gas Ltd.’s 2018 first quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three months ended March 31, 2018 and the audited consolidated financial statements and related notes for the year ended December 31, 2017. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”), which are also generally accepted accounting principles (“GAAP”) for publicly accountable enterprises in Canada. All amounts are in Canadian dollars unless otherwise noted. All references to “Zargon” or the “Company” refer to Zargon Oil & Gas Ltd.

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

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

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

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

- *The Company uses the term “debt net of working capital” or “net debt”. Debt net of working capital, as presented, does not have any standardized meaning prescribed by IFRS and may not be comparable with the calculation of similar measures for other entities. Debt net of working capital, as used by the Company, is calculated as the convertible debenture of $41.94 million ($57.50 million prior to March 31, 2017) and any working capital 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, asset retirement expenditures per boe, cash portion of exploration and evaluation per boe, other expense per boe and current income taxes per boe. Funds flow netbacks are a useful measure to compare the Company’s operations with those of its peers.*

References to "production volumes" or "production" in this document refer to sales volumes.

Forward-Looking Statements – This document offers our assessment of Zargon's future plans and operations as at May 14, 2018, and contains forward-looking statements including:

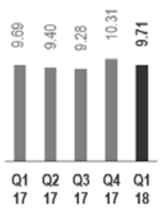
- *our expectations for the improvement in our WTI-WCS differentials referred to under the heading "Discussion";*
- *our expectations for our remaining 2018 operating and transportation expenses referred to under the heading "Discussion";*
- *our expectations for our production referred to under the heading "Discussion";*
- *our expected sources of funds for capital expenditures referred to under the heading "Liquidity and Capital Resources;*
- *our expectations for our remaining first half of 2018 capital budget program and the second half of 2018 capital budget program referred to under the heading "Discussion"; and*
- *our strategic alternatives process referred to under the headings "Strategic Alternatives Process Update" and "Outlook".*

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

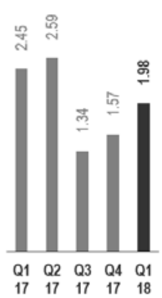
You are cautioned that the assumptions, including among other things, future oil and natural gas prices; future capital expenditure levels (including ASP); future production levels; future exchange rates; the cost of developing and expanding our assets; our ability to obtain equipment in a timely manner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

This MD&A has been prepared as of May 14, 2018.

Petroleum and Natural Gas Revenue
($ millions)



Natural Gas Prices
($/mcf)



Oil and Liquids Prices
($/bbl)

FINANCIAL & OPERATING RESULTS

Petroleum and Natural Gas Sales

	Three months ended March 31,		
($ millions)	**2018**	2017	Percent Change
Petroleum sales	**9.20**	8.94	3
Natural gas sales	**0.51**	0.75	(32)
Petroleum and natural gas sales	**9.71**	9.69	–

First quarter 2018 gross petroleum and natural gas sales of $9.71 million were six percent below the $10.31 in the preceding quarter but consistent with the $9.69 million in the first quarter of 2017. First quarter 2018 realized oil and liquids field prices averaged $52.48 per barrel before the impact of financial risk management contracts and were six percent higher than the $49.30 per barrel recorded in the 2017 first quarter. The quarter over quarter decrease in sales was due to a significantly increased Western Canadian Select ("WCS") price differential of $30.76 per barrel, compared to $15.60 per barrel in the fourth quarter of 2017. Our Alberta field price ties closely with the WCS prices, and despite a 13 percent first quarter of 2018 over fourth quarter 2017 improvement in WTI prices expressed in Canadian dollars, our corresponding Alberta field price decreased nine percent. Natural gas field prices received averaged $1.98 per thousand cubic feet in the first quarter of 2018, a 19 percent decrease from the 2017 first quarter prices.

Pricing

	Three Months Ended March 31,		
Average for the period	**2018**	2017	Percent Change
Natural Gas:			
NYMEX average daily spot price ($US/mmbtu)	**3.01**	3.00	–
AECO average daily spot price ($Cdn/mmbtu)	**2.08**	2.69	(23)
Zargon realized field price ($Cdn/mcf)	**1.98**	2.45	(19)
Zargon realized natural gas field price differential ($Cdn/mcf)	**0.10**	0.24	(58)
Crude Oil:			
WTI ($US/bbl)	**62.87**	51.91	21
Edmonton par price ($Cdn/bbl)	**72.18**	63.89	13
Western Canadian Select ("WCS") price ($Cdn/bbl)	**48.76**	49.36	(1)
Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl)	**52.48**	49.30	6
Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl)	**47.63**	49.47	(4)
Zargon realized oil field price differential (1)	**19.70**	14.59	35
WTI ($Cdn/bbl) to WCS ($Cdn/bbl) differential	**30.76**	19.28	60

(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 2018 first quarter were 1,949 barrels per day, a one percent increase from the preceding quarter rate of 1,924 barrels per day due to our 2017 waterflood modification, reactivations and recompletion programs offset by the reduction in conventional capital spending. Natural gas production volumes decreased three percent in the 2018 first quarter to 2.87 million cubic feet per day compared to 2.95 million cubic feet per day in the prior quarter (Q1 2017 – 3.38 million cubic feet per day). Natural gas production declines continued as a result of the shut-in of uneconomic gas production resulting from low field prices and naturally occurring production declines.

Production by Core Area

Three Months Ended March 31,		**2018**			2017	
	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	**520**	**1.30**	**736**	563	1.78	860
Alberta Plains South	**1,008**	**1.57**	**1,270**	1,099	1.60	1,365
Williston Basin	**421**	**–**	**421**	354	–	354
	1,949	**2.87**	**2,427**	2,016	3.38	2,579

Risk Management Contracts

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

For accounting purposes, an unrealized gain or loss from forward sale commodity contracts is recorded based on the fair value ("mark-to-market") of the contracts at the period end. Realized and unrealized gains/losses 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 2018 first quarter, lower contract prices versus WTI oil prices resulted in a net realized loss on derivatives of $0.85 million compared to a $0.03 million net realized gain in the first quarter of 2017.

The unrealized loss on derivatives in the first quarter of 2018 was related to oil contract losses of $0.36 million compared to $1.83 million gain in the first quarter of 2017. These non-cash unrealized derivative gains or losses are generated by the change over the reporting period in the mark-to-market valuation of Zargon's risk management contracts. Commodity price volatility has resulted in significant fluctuations in the mark-to-market amount of unrealized derivative assets and liabilities. Zargon's commodity risk management positions are described in Notes 11 and 12 to the unaudited interim consolidated financial statements.

Royalties

	Three months ended March 31,		
($ millions)	**2018**	2017	Percent Change
Royalties	**1.29**	1.00	29
Percentage of revenue	**13.2%**	10.3%	

First quarter 2018 royalties of $1.29 million increased eight percent compared to the prior quarter and 29 percent from the 2017 first quarter, primarily due to the increase in crude oil prices. The variations in royalty rates generally track changes in production and volumes. First quarter of 2018 royalties were 13.2 percent of gross sales compared to 10.3 percent in the first quarter of 2017.

Operating Expenses and Transportation Expenses

	Three months ended March 31,		
($ millions)	**2018**	2017	Percent Change
Operating expenses	**5.89**	5.08	16
Transportation expenses	**0.12**	0.03	300
Total expenses	**6.01**	5.11	18
Total expenses ($/boe)	**27.52**	22.01	25

First quarter 2018 operating expenses and transportation expenses of $6.01 million on a total dollar basis were up compared to $5.03 million recorded in the prior quarter and $5.11 million recorded in the first quarter of 2017. First quarter 2018 operating costs were significantly higher than expectations due to a combination of workover expenditures (non-capitalized) on a set of challenging reactivations, higher electricity costs and cold weather related operational costs. Looking forward, we anticipate operating costs to return to historical totals as the impact of higher electricity costs is offset by the reduction of costs realized from the shut-in of uneconomic natural gas properties.

Operating Netbacks

Three Months Ended March 31,	**2018**		2017	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**52.48**	**1.98**	49.30	2.45
Royalties	**(7.30)**	**(0.02)**	(5.28)	(0.12)
Realized gain/(loss) on derivatives	**(4.85)**	**–**	0.17	–
Operating expenses	**(27.57)**	**(4.08)**	(23.48)	(2.68)
Transportation expenses	**(0.68)**	**–**	(0.19)	–
Operating netbacks	**12.08**	**(2.12)**	20.52	(0.35)

General & Administrative ("G&A") Expenses

	Three months ended March 31,		
($ millions)	**2018**	2017	Percent Change
G&A expenses	**0.97**	1.16	(16)
G&A expenses ($/boe)	**4.43**	4.99	(11)

G&A expenses of $0.97 million and $4.43 per barrel of oil equivalent in the first quarter of 2018 reflected Zargon's ongoing G&A cost containment initiatives and were lower than the $1.16 million and $1.00 million reported in the first quarter of 2017 and the fourth quarter of 2017, respectively.

Transaction Costs

Transaction costs for the 2018 first quarter were $0.07 million compare to $0.03 million in the prior quarter and $0.11 million in the first quarter of 2017 and related to Zargon's ongoing strategic alternatives review.

Interest and Financing Charges on Bank Debt

Interest and financing income in the 2018 first quarter and in the prior quarter were essentially nil, and compares to the $0.02 million of the interest and financing income in the first quarter of 2017. Interest and financing charges are minimal since 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).

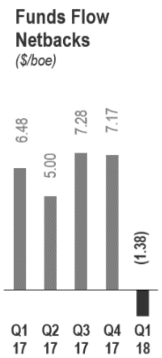
Interest charges of $0.84 million in the first quarter of 2018 were unchanged compared to both the prior quarter and the first quarter of 2017. For more details, please refer to Note 7 of the interim consolidated financial statements.

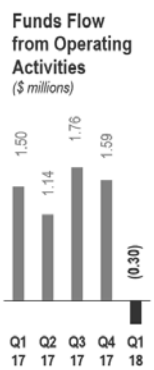
Current Tax

The current tax expense for the first quarter of 2018 and the prior quarter were nil (Q1 2017 – nil). Total corporate tax pools as at March 31, 2018 are approximately $199 million, comparable to the $197 million of tax pools available to Zargon at December 31, 2017.

Estimated Tax Pools

($ millions)	March 31, 2018
Canadian oil and natural gas property expenses	–
Canadian development expenses	**12**
Canadian exploration expenses	**6**
Capital cost allowance	**24**
Non-capital losses	**154**
US tax pools	**1**
Other	**2**
Estimated tax pools	**199**





Corporate Netbacks

	Three Months Ended March 31,	
($/boe)	**2018**	2017
Petroleum and natural gas sales	**44.47**	41.74
Royalties	**(5.88)**	(4.29)
Realized gain on derivatives	**(3.89)**	0.13
Operating expenses	**(26.97)**	(21.86)
Transportation expenses	**(0.55)**	(0.15)
Operating netbacks	**7.18**	15.57
General and administrative expenses	**(4.43)**	(4.99)
Transaction costs	**(0.30)**	(0.46)
Interest and financing charges	**0.01**	0.06
Interest on convertible debentures	**(3.84)**	(3.70)
Current tax recovery	**–**	–
Funds flow netbacks	**(1.38)**	6.48

Depletion and Depreciation Expense

Depletion and depreciation expense for the first quarter of 2018 decreased six percent at $3.21 million compared to $3.41 million in the first quarter of 2017. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $14.68 and $14.69 for the first quarter of 2018 and 2017, respectively. The 2017 calendar year depletion and depreciation rate was $14.58 per barrel of oil equivalent.

Accretion of Asset Retirement Obligations and Convertible Debentures

The accretion expense of asset retirement obligations for the first three months of 2018 was $0.37 million was essentially unchanged compared to the first quarter of 2017. Year-over-year adjustments are due to actual abandonment and reclamation costs 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 ($51.70 million prior to March 31, 2017). Accretion on the convertible debenture for the 2018 first quarter is $0.11 million compared to $0.37 million in the 2017 first quarter.

Shared-based Compensation

Expensing of share-based compensation in the first quarter of 2018 totalled $0.04 million, which is slightly lower than the $0.05 million incurred in the first quarter of 2017.

Unrealized Foreign Exchange

The Company had an unrealized foreign exchange gain of $0.02 million during the first quarter of 2018 compared to a gain of $0.01 million in the prior quarter (Q1 2017 – $0.04 million loss). 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 2018 first quarter of nil million compared to first quarter of 2017 expenses of $0.05 million. Exploration and evaluation expenses are primarily related to undeveloped land expiries.

Deferred Tax

The deferred tax expense for the first quarter of 2018 was essentially nil compared to a recovery of $0.10 million in the first quarter of 2017.

Funds Flow from Operating Activities

Funds flow from operating activities in the 2018 first quarter was a negative $0.30 million and compares with the $1.59 million and $1.50 million reported in the preceding quarter and the first quarter of 2017, respectively. The decrease in funds flow compared to the prior quarter and the 2017 first quarter was primarily a result of higher operating and transportation expenses and a significant realized derivatives loss.

Details of the change in fund from operating activities during 2018 and 2017 are as follows:

	2018	2017			
($ millions)	**Q1**	Q4	Q3	Q2	Q1
Funds flow from operating activities, beginning of quarter	**1.59**	1.76	1.14	1.50	0.92
Revenue and royalties:					
Volume	**(0.17)**	(0.75)	0.59	(0.19)	0.28
Price	**(0.42)**	1.78	(0.72)	(0.09)	0.17
Royalties	**(0.09)**	(0.06)	(0.02)	(0.12)	0.03
Realized Derivatives	**(0.24)**	(0.84)	0.26	(0.06)	0.03
Expenses:					
Operating and transportation	**(0.98)**	(0.16)	0.24	–	(0.24)
General and administrative	**0.03**	(0.11)	0.22	0.05	0.17
Transaction costs	**(0.03)**	0.01	0.01	0.05	0.07
Interest and financing	**0.01**	(0.01)	0.01	–	0.05
Current taxes	**–**	(0.03)	0.03	–	0.02
Funds flow from operating activities, end of quarter	**(0.30)**	1.59	1.76	1.14	1.50

Net Loss

A net loss of $4.33 million for the 2018 first quarter was 702 percent higher than the $0.54 million net loss in the first quarter of 2017, largely due to higher royalties, operating expenses and loss on realized and unrealized derivatives. The net earnings/(loss) track the funds flow from operating activities for the respective periods and non-cash charges, which include depletion and depreciation, unrealized derivative gain/(loss), land expiries, accretion, gain on convertible debentures and deferred taxes. On a per diluted share basis, the 2018 first quarter net loss was $0.14, compared to a net loss of $0.02 from the 2017 first quarter.

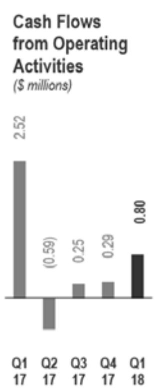
Capital Expenditures

	Three Months Ended March 31,	
($ millions)	**2018**	2017
Undeveloped land	**0.33**	0.49
Geological and geophysical (seismic)	**0.05**	0.16
Drilling and completion of wells	**0.30**	0.34
Well equipment and facilities	**0.33**	0.49
ASP project and exploitation costs	**0.23**	0.35
ASP chemical costs	**0.65**	0.54
Exploration and development	**1.89**	2.37
Property acquisitions	**–**	0.13
Property dispositions	**(0.41)**	–
Net property acquisitions	**(0.41)**	0.13
Total net capital expenditures excluding administrative assets	**1.48**	2.50
Administrative assets	**0.02**	0.01
Total net capital expenditures	**1.50**	2.51

LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property acquisitions) totalled $1.50 million in the first quarter of 2018 and were 40 percent lower than the same period in 2017. Field expenditures of $1.89 million for the first quarter of 2018 were 20 percent lower than the 2017 first quarter. The first quarter 2018 field capital expenditures (excluding net property acquisitions) were allocated to Alberta Plains North - $0.22 million, Alberta Plains South - $1.40 million and Williston Basin - $0.27 million and included the drilling of nil net wells, unchanged from the first quarter of 2017.

Included in the Alberta Plains South capital expenditures is the $0.88 million incurred on the Little Bow ASP project. Of the total ASP amount, $0.23 million was spent on project and exploitation costs while $0.65 million was spent on chemical costs for the facility.



At March 31, 2018, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $40.79 million, which compares to $38.41 million of net debt at the end of December 31, 2017. The $40.79 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 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).

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 March 31, 2018, net capital expenditures totalled $1.50 million, which was $0.70 million higher than the cash flows from operating activities (after changes in non-cash working capital) of

$0.80 million. For the quarter ended March 31, 2017, net capital expenditures totalled $2.51 million, which was $0.01 million lower than the cash flows from operating activities (after changes in non-cash working capital) of $2.52 million. Zargon relies on access to debt and capital markets to the extent that net capital expenditures exceed cash flows from operating activities (after changes in non-cash working capital). Over the long term, Zargon expects to fund capital expenditures with its cash flows from operating activities; however, it may fund growth through additional debt and equity issuances. In the crude oil and natural gas industry, because of the nature of reserve reporting, the natural reservoir declines and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities. Therefore, maintenance capital is not disclosed separately from development capital spending.

At May 14, 2018, Zargon Oil & Gas Ltd. had 30.86 million common shares outstanding. Pursuant to the stock option plan and the share award plan, there are currently an additional 0.32 million common share awards issued and outstanding and 1.25 million stock options issued and outstanding.

Capital Sources and Uses

	Three Months Ended March 31,	
($ millions)	**2018**	2017
Funds flow from/(used in) operating activities	**(0.30)**	1.50
Change in cash	**1.23**	14.68
Change in convertible debenture	**–**	(13.37)
Asset retirement costs	**(0.61)**	(0.14)
Changes in working capital and other	**1.18**	(0.16)
Total capital sources	**1.50**	2.51

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	2018	2019 to 2020	2021 to 2022	Thereafter
Head office lease and other	0.23	0.13	0.10	–	–
ASP related contracts	0.10	0.10	–	–	–
Total	0.33	0.23	0.10	–	–

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 May 5, 2018, Zargon's LMR was 1.33. 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 Financial Statements.

FUTURE CHANGES IN ACCOUNTING POLICIES

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

MANAGEMENT AND FINANCIAL REPORTING SYSTEMS

Zargon is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings", otherwise referred to as Canadian SOX ("C-Sox"). The 2018 certificate requires that the Company disclose in the interim MD&A any changes in the Company's internal controls over financial reporting that occurred during the period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. The Company confirms that no such changes were made to the internal controls over financial reporting during the first quarter of 2018.

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. 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				**2018**
	Q1	Q2	Q3	Q4	**Q1**
Petroleum and natural gas sales ($ millions)	9.69	9.40	9.28	10.31	**9.71**
Net loss ($ millions)	(0.54)	(1.71)	(3.51)	(3.55)	**(4.33)**
Net loss per diluted share ($)	(0.02)	(0.06)	(0.11)	(0.12)	**(0.14)**
Funds flow from/(used in) operating activities ($ millions)	1.50	1.14	1.76	1.59	**(0.30)**
Funds flow from/(used in) operating activities per diluted share ($)	0.05	0.04	0.06	0.05	**(0.01)**
Cash flows from operating activities ($ millions)	2.52	(0.59)	0.25	0.29	**0.80**
Cash flows from operating activities per diluted share ($)	0.08	(0.02)	0.01	0.01	**0.03**
Net capital expenditures ($ millions)	2.51	2.13	1.77	2.45	**1.50**
Total assets ($ millions)	153.75	150.11	144.76	140.55	**136.83**
Convertible debentures ($ millions) (1)	41.94	41.94	41.94	41.94	**41.94**
Net debt	35.09	36.06	36.70	38.41	**40.79**
Average daily oil and liquids production (bbl)	2,016	1,921	2,037	1,924	**1,949**
Average daily natural gas production (mmcf)	3.38	3.47	3.55	2.95	**2.87**
Average daily production (boe)	2,579	2,500	2,628	2,416	**2,427**
Average oil production weighting (%)	78	77	78	80	**80**
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	41.74	41.34	38.36	46.37	**44.47**
Funds flow netback ($/boe) (2)	6.48	5.00	7.28	7.17	**(1.38)**

(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 (loss)/earnings ($ millions)	(8.82)	(5.27)	11.73	(17.81)
Net (loss)/earnings per diluted share ($)	(0.29)	(0.17)	0.38	(0.58)
Funds flow from/(used in) operating activities ($ millions)	(0.40)	3.56	(0.51)	0.92
Funds flow from/(used in) operating activities per diluted share ($)	(0.01)	0.12	(0.01)	0.03
Cash flows from operating activities ($ millions)	2.07	1.18	3.19	(1.77)
Cash flows from 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) (1)	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)	(1.05)	9.77	(1.58)	4.07

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

Additional information regarding the Company and its business operations, including the Company's Annual Information Form for December 31, 2017, is available on the Company's SEDAR profile at www.sedar.com.

CONSOLIDATED BALANCE SHEETS

(unaudited)

($ thousands)	Notes	**March 31, 2018**	December 31, 2017
ASSETS			
Cash and cash equivalents		**2,861**	4,095
Trade and other receivables		**3,569**	3,888
Deposits and prepaid expenses		**1,703**	1,908
Total current assets		**8,133**	9,891
Long term deposits		**18**	18
Property, plant and equipment, net	4	**126,890**	128,908
Intangible exploration and evaluation assets	5	**1,790**	1,735
Total assets		**136,831**	140,552
LIABILITIES			
Trade and other payables		**6,977**	6,362
Derivatives	11,12	**1,507**	1,151
Total current liabilities		**8,484**	7,513
Convertible debentures	7	**41,061**	41,461
Asset retirement obligations	6	**63,971**	64,812
Deferred tax liabilities		**4,159**	4,045
Total liabilities		**117,675**	117,831
Commitments and contingencies	6,13		
EQUITY			
Shareholders' capital	8	**262,518**	262,231
Accumulated other comprehensive income		**4,629**	4,412
Contributed surplus	10	**9,403**	9,651
Equity component of debentures	7	**3,570**	3,570
Deficit		**(260,964)**	(257,143)
Total equity		**19,156**	22,721
Total equity and liabilities		**136,831**	140,552

See accompanying notes to the interim consolidated financial statements.

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

(unaudited)		Three Months Ended March 31,	
($ thousands, except per share amounts)	Notes	**2018**	2017
Petroleum and natural gas sales	9	**9,713**	9,689
Royalties		**(1,285)**	(996)
PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES		**8,428**	8,693
Gain/(loss) on unrealized derivatives	11,12	**(356)**	1,829
Gain/(loss) on realized derivatives	11,12	**(850)**	31
GAIN/(LOSS) ON DERIVATIVES		**(1,206)**	1,860
TOTAL INCOME		**7,222**	10,553
Operating		**5,890**	5,075
Transportation		**120**	35
General and administrative		**968**	1,159
Transaction costs		**66**	107
Exploration and evaluation	5	**–**	50
Gain on convertible debentures	7	**–**	(458)
Gain on sale of properties	4	**(29)**	–
Share-based compensation	10	**39**	53
Unrealized foreign exchange (gain)/loss		**(19)**	37
Impairment loss on marketable securities		**–**	135
Depletion and depreciation	4	**3,206**	3,410
EXPENSES		**10,241**	9,603
EARNINGS/(LOSS) BEFORE FINANCE EXPENSES AND INCOME TAXES		**(3,019)**	950
Interest and financing charges		**(2)**	(15)
Interest on convertible debentures	7	**838**	860
Accretion on convertible debentures	7	**113**	373
Accretion of asset retirement obligations	6	**365**	371
FINANCE EXPENSES		**1,314**	1,589
LOSS BEFORE INCOME TAXES		**(4,333)**	(639)
Current tax recovery		**–**	–
Deferred tax expense/(recovery)		**1**	(96)
INCOME TAXES EXPENSE/(RECOVERY)		**1**	(96)
NET LOSS FOR THE PERIOD		**(4,334)**	(543)
Currency translation adjustment recognized in other comprehensive loss		**217**	(79)
OTHER COMPREHENSIVE EXPENSE/(LOSS) FOR THE PERIOD		**217**	(79)
TOTAL COMPREHENSIVE EXPENSE/(LOSS) FOR THE PERIOD		**(4,117)**	(622)
NET LOSS PER SHARE			
Basic		**(0.14)**	(0.02)
Diluted		**(0.14)**	(0.02)

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, 2017		**262,231**	**4,412**	**9,651**	**3,570**	**(257,143)**	**22,721**
Net loss for the period		**–**	**–**	**–**	**–**	**(4,334)**	**(4,334)**
Share-based compensation	10	**–**	**–**	**39**	**–**	**–**	**39**
Exercise of share awards	8	**287**	**–**	**(287)**	**–**	**–**	**–**
Convertible debenture IFRS 9 adoption	7	**–**	**–**	**–**	**–**	**513**	**513**
Translation differences on foreign subsidiary		**–**	**217**	**–**	**–**	**–**	**217**
Balance at March 31, 2018		**262,518**	**4,629**	**9,403**	**3,570**	**(260,964)**	**19,156**
Balance at December 31, 2016		260,902	4,902	10,614	3,640	(247,833)	32,225
Net loss for the period		–	–	–	–	(543)	(543)
Share-based compensation	10	–	–	53	–	–	53
Exercise of share awards	8	894	–	(894)	–	–	–
Equity component of convertible debentures	7	–	–	–	(70)	–	(70)
Translation differences on foreign subsidiary		–	(79)	–	–	–	(79)
Balance at March 31, 2017		261,796	4,823	9,773	3,570	(248,376)	31,586

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)		Three Months Ended March 31,	
($ thousands)	Notes	**2018**	2017
OPERATING ACTIVITIES			
Net loss for the period		**(4,334)**	(543)
Adjustments for non-cash items:			
Gain on convertible debenture	7	**–**	(458)
Gain on sale of properties		**(29)**	–
(Gain)/loss on unrealized derivatives	11,12	**356**	(1,829)
Depletion and depreciation	4	**3,206**	3,410
Accretion of asset retirement obligations	6	**365**	371
Accretion of convertible debentures	7	**113**	373
Share-based compensation	10	**39**	53
Unrealized foreign exchange (gain)/loss		**(19)**	37
Impairment loss on marketable securities		**–**	135
Deferred tax expense/(recovery)		**1**	(96)
Exploration and evaluation expenses	5	**–**	50
Funds flow from/(used in) operating activities		**(302)**	1,503
Asset retirement expenditures	6	**(613)**	(143)
Changes in operating working capital		**1,715**	1,164
Net cash from operating activities		**800**	2,524
INVESTING ACTIVITIES			
Additions to property, plant and equipment	4	**(1,862)**	(2,383)
Additions to intangible exploration and evaluation assets	5	**(46)**	(123)
Proceeds from disposal of property, plant and equipment	4	**411**	–
Change in long term deposits		**–**	(403)
Changes in investing working capital		**(537)**	1,120
Net cash used in investing activities		**(2,034)**	(1,789)
FINANCING ACTIVITIES			
Redemption of convertible debentures, including transaction costs	7	**–**	(13,370)
Changes in financing working capital	7	**–**	(2,047)
Net cash (used in)/provided by financing activities		**–**	(15,417)
NET CHANGE IN CASH DURING THE PERIOD		**(1,234)**	(14,682)
CASH, BEGINNING OF PERIOD		**4,095**	24,855
CASH, END OF PERIOD		**2,861**	10,173

See accompanying notes to the interim consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the three months ended March 31, 2018, with comparative figures for 2017 (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 1100, 112 - 4th Avenue SW, Calgary, Alberta. The consolidated financial statements of the Company as at and for the period ended March 31, 2018 and its 2017 comparative periods are comprised of the Company and its wholly owned subsidiaries. The Company is engaged in the exploration, development and production of oil and natural gas in Canada and the United States (“US”) and conducts many of its activities jointly with others; these financial statements reflect only the Company’s proportionate interest in such activities.

2. BASIS OF PRESENTATION

(a) Statement of compliance:

The unaudited interim consolidated financial statements for the three month period ended March 31, 2018 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, 2017 with the exception of new and amended accounting standards that have been evaluated and disclosed in Note 3. The disclosures provided below are incremental to those included with the audited annual consolidated financial statements. These unaudited interim consolidated financial statements for the three month period ended March 31, 2018 should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2017. These consolidated financial statements were approved and authorized for issue by the Board of Directors on May 14, 2018.

(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:

- On January 1, 2018, Zargon adopted IFRS 9 “Financial Instruments”. IFRS 9 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. The Company has evaluated the impact of adopting IFRS 9 and has concluded that the new standard has the following impacts on the company:

  i. IFRS 9 has revised the method to account for convertible debenture modifications by removing the option to defer and amortize the difference in present values between the pre-modified cash flows and the new cash flows over the remaining life of the newly modified liability, and as such, the carrying value of the convertible debenture was adjusted in the current quarter to conform to IFRS 9.

  ii. Classification

  Financial instruments are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, financial instruments are measured based on their classification as described below:

  - Fair value through profit or loss: Financial instruments under this classification include derivative asset and liabilities.

  - Amortized cost: Financial instruments under this classification include cash, accounts receivable, accounts payable and long term debt.

  iii. Impairment

  IFRS 9 replaces the “incurred loss” model under IAS 39 with an “expected credit loss” model for financial assets carried at amortized cost, and fair value through OCI. Zargon has applied the expected credit loss model to financial assets classified as amortized cost using the simplified approach applying a provision matrix whereby accounts are grouped into categories based on counterparty characteristics and aging categories. The application of the expected credit loss model did not result in an adjustment upon transition.

- On January 1, 2018, Zargon adopted IFRS 15 “Revenue from Contracts with Customers”, which 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. The Company has assessed the impact of adopting IFRS 15 and there is no material impact on the Company’s consolidated financial statements. As a result of this adoption, Zargon has revised the description of its accounting policy for revenue recognition as follows:

  Revenue recognition

  Revenue from the sale of crude oil, natural gas and natural gas liquids is measured based on the consideration specified in contracts with buyers. Revenue from contracts is recognized when or as Zargon satisfies a performance obligation by transferring a promised good or sale to a buyer. A good or service is transferred when the buyer obtains control of that good or service. The transfer of control of oil, natural gas, natural gas liquids usually coincides with the title passing to the buyer and the buyer taking physical possession. The transaction price for variable price contracts is based on the commodity price, adjusted for quality, location and other factors.

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

- 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, 2017	**295,292**
Accumulated depletion and depreciation	**(166,384)**
Net carrying amount, December 31, 2017	**128,908**
Additions	**1,862**
Disposals	**(382)**
Change in asset retirement obligation	**(775)**
Exchange differences	**483**
Depletion and depreciation	**(3,206)**
Net carrying amount, March 31, 2018	**126,890**
Cost, March 31, 2018	**296,940**
Accumulated depletion and depreciation	**(170,050)**
Net carrying amount, March 31, 2018	**126,890**

During the first quarter of 2018, the Company disposed of certain assets for gross proceeds of $0.44 million (Q1 2017 – nil). The disposition for the first quarter of 2018 resulted in gain of $0.03 million (Q1 2017 – nil).

5. INTANGIBLE EXPLORATION AND EVALUATION ASSETS

($ thousands)

Cost, December 31, 2017	**1,735**
Additions	**46**
Exploration and evaluation expense	**–**
Exchange differences	**9**
Cost, March 31, 2018	**1,790**

6. ASSET RETIREMENT OBLIGATIONS

($ thousands)

Balance at December 31, 2017	**64,812**
Foreign exchange and other	**182**
Asset retirement expenditures	**(613)**
Asset retirement obligations related to dispositions	**(122)**
Revisions to estimated asset retirement obligations	**(653)**
Accretion	**365**
Balance at March 31, 2018	**63,971**

The asset retirement obligations were calculated using a discount factor of 2.25 percent (December 31, 2017 – 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, 2017 – 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.

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)	**March 31, 2018**	December 31, 2017
Principal, beginning of year	**41,941**	57,500
Redemption	**–**	(15,559)
Principal, end of period	**41,941**	41,941
Debt component, beginning of year	**41,461**	56,671
Cash consideration	**–**	(14,842)
Gain on convertible debenture	**–**	(458)
Transaction costs	**–**	(505)
IFRS 9 adoption	**(513)**	–
Accretion of convertible debentures	**113**	595
Debt component, end of period	**41,061**	41,461
Equity component, beginning of year	**3,570**	3,640
Transaction costs	**–**	(70)
Equity component, end of period	**3,570**	3,570

8. SHARE CAPITAL

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

Common Shares

	Three Months Ended March 31, 2018	
(thousands)	**Number of Shares**	**Amount ($)**
Balance, as at December 31, 2017	**30,801**	**261,231**
Share awards exercised	**54**	**–**
Share-based compensation transferred from contributed surplus on exercise of share awards	**–**	**287**
Balance, as at March 31, 2018	**30,855**	**262,518**

9. REVENUE

The company derives its revenue from contacts with customers primarily through the transfer of commodities representing the following major product types:

	Three Months Ended March 31,	
($ thousands)	**2018**	2017
Petroleum sales	**9,203**	8,944
Natural gas sales	**510**	745
Petroleum and natural gas sales	**9,713**	9,689

At March 31, 2018, receivables from contracts with customers, which are included in trade accounts receivable, were $2.95 million (at March 31, 2017 – $3.23 million).

10. SHARE-BASED PAYMENTS

Stock Option Plan

On March 24, 2017, Zargon granted an aggregate of 1.34 million stock options to our directors, officers and certain employees at an exercise price of $0.72 per share under the Plan. Of these, 0.32 million options were granted to our non-management directors, 0.54 million options were granted to our officers and the balance of 0.48 million stock options were granted to employees. One-third of the options vested on December 31, 2017, one-third will vest on December 31, 2018 and the balance will vest 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:

	Three Months Ended March 31, 2018
	Number of Stock Options (thousands)
Outstanding, as at December 31, 2017	**1,250**
Share awards forfeited	**–**
Outstanding, as at March 31, 2018	**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:

	Three Months Ended March 31, 2018
	Number of Share Awards (thousands)
Outstanding, as at December 31, 2017	**363**
Share awards granted	**10**
Share awards exercised	**(54)**
Share awards forfeited	**–**
Outstanding, as at March 31, 2018	**319**

Share-based Compensation

The stock options/share awards for the three months ended March 31, 2018, resulted in share-based compensation of $0.04 million (2017 - $0.05 million).

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 March 31,	
(thousands of shares)	**2018**	2017
Weighted average number of common shares – basic	**30,844**	30,668
Weighted average number of common shares – diluted	**30,844**	30,806

Dilution amounts for the three months ended March 31, 2018 of nil million shares (2017 – 0.14 million 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 share rights according to the treasury stock method.

The convertible debenture could potentially dilute basic earnings per share, but were not included in the calculation of diluted earnings per share because they are antidilutive for the three months ended March 31, 2018 and 2017, respectively.

11. FINANCIAL INSTRUMENTS

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

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

	March 31, 2018		December 31, 2017	
(thousands)	**Carrying Value ($)**	**Fair Value ($)**	Carrying Value ($)	Fair Value ($)
Amortized cost:				
Cash and cash equivalents	**2,861**	**2,861**	4,095	4,095
Trade and other receivables	**3,569**	**3,569**	3,888	3,888
Trade and other payables	**6,977**	**6,977**	6,362	6,362
Convertible debentures	**41,061**	**33,133**	41,461	34,496
Fair value through profit and loss:				
Derivative assets	**–**	**–**	–	–
Derivative liabilities	**1,507**	**1,507**	1,151	1,151

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.

- Level I

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

- Level II

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

- Level III

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

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

At each reporting date, the Company determines whether transfers have occurred between levels in the hierarchy by reassessing the level of classification for each financial asset and financial liability measured or disclosed at fair value in the consolidated financial statements. Assessment of the significance of a particular input to the fair value measurement requires judgement and may affect the placement within the fair value hierarchy. During the period ended March 31, 2018, there were no transfers between levels I, II or III.

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

Financial Risk Management

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

- Market Risk

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

  - Commodity Price Risk

  Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result in changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and

United States dollar, but also world economic events that dictate the levels of supply and demand. As a means of mitigating exposure to commodity price risk volatility, the Company has entered into various derivative agreements. The use of derivative instruments is governed under formal policies and is subject to limits established by the Board of Directors. The Company's policy is to not use derivative financial instruments for speculative purposes.

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

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

- Interest Rate Risk

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

- Foreign Exchange Risk

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. As Zargon operates in North America, fluctuations in the exchange rate between the US/Canadian dollar can have a significant effect on the Company's reported results. A $0.01 change in the US to Canadian dollar exchange rate would have resulted in a $0.05 million (March 31, 2017 - $0.05 million) increase or decrease in net earnings for the period ended March 31, 2018. In order to mitigate the Company's exposure to foreign exchange fluctuations, the Company may enter into foreign exchange derivative agreements.

- Credit Risk

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

The maximum credit risk exposure associated with accounts receivable and derivative assets is the total carrying value. The Company monitors these balances monthly to limit the risk associated with collection. Of Zargon's accounts receivable at March 31, 2018, approximately 88 percent (December 31, 2017 - 89 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts at March 31, 2018 was $0.08 million (December 31, 2017 - $0.02 million). During 2018, the Company did not record any additional provision for non-collectible accounts receivable.

As at March 31, 2018, $0.08 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	**6,977**	**–**	**6,977**
Derivative liabilities	**1,507**	**–**	**1,507**
Interest on convertible debentures	**3,355**	**2,528**	**5,883**
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 $0.90 million (March 31, 2017 – $1.79 million) for oil risk management contracts impacting net earnings for the three months ended March 31, 2018, respectively.

12. DERIVATIVE CONTRACTS

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production. The Company enters into these contracts for risk management purposes only in order to protect a portion of its future cash flows from the volatility of oil and natural gas commodity prices and interest rates. For financial risk management contracts, any unrealized gains or losses are recorded in earnings based on the fair value (mark-to-market) of the contracts at each reporting period. The unrealized loss on the statement of earnings/(loss) and comprehensive income/(loss) for the first three months of 2018 was $0.36 million and the unrealized gain for the first three months of 2017 was $1.83 million. The realized loss on the statement of earnings/(loss) and comprehensive income/(loss) for the first three months of 2018 was $0.85 million and the realized gain for the first three months of 2017 was $0.03 million.

As at March 31, 2018, the Company had the following outstanding commodity and interest risk management contracts:

Commodity Financial Risk Management Contracts:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Asset ($ thousands)
Oil swaps	500 bbl/d	$69.00 Cdn/bbl (WTI)	Q1 2018 hedge, settled on Apr. 6/18	**(189)**
	500 bbl/d	$71.00 Cdn/bbl (WTI)	Apr. 1/18 – Jun. 30/18	**(560)**
	500 bbl/d	$71.30 Cdn/bbl (WTI)	Q1 2018 hedge, settled on Apr. 6/18	**(153)**
	500 bbl/d	$70.00 Cdn/bbl (WTI)	Apr. 1/18 – Jun. 30/18	**(605)**
Total Fair Market Value, Commodity Price Financial Contracts				**(1,507)**

Oil swaps are settled against the NYMEX WTI pricing index.

13. 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)	March 31, 2018
Less than one year	**0.23**
Between one and five years	**0.10**
	0.33

CORPORATE INFORMATION

BOARD OF DIRECTORS

Craig H. Hansen
Calgary, Alberta

Kyle D. Kitagawa (1)
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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