PERPETUAL
ENERGY

# 2016

# CONSOLIDATED FINANCIAL STATEMENTS

## MANAGEMENT'S REPORT

The consolidated financial statements of Perpetual Energy Inc. ("the Company") are the responsibility of Management and have been approved by the Board of Directors of the Company. These consolidated financial statements have been prepared by Management in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and the Interpretations of the IFRS Interpretations Committee.

The consolidated financial statements are audited and have been prepared using accounting policies in accordance with IFRS. The preparation of Management's Discussion and Analysis is based on the Company's financial results which have been prepared in accordance with IFRS. It compares the Company's financial performance in 2016 to 2015 and should be read in conjunction with the consolidated financial statements and accompanying notes.

Management is responsible for establishing and maintaining adequate internal control over the Company's financial reporting. Management believes that the system of internal controls that have been designed and maintained at the Company provide reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements. The internal accounting control process includes Management's communication to employees of policies which govern ethical business conduct.

Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Board of Directors has appointed an Audit Committee consisting of unrelated, non-management directors which meets at least four times during the year with Management and independently with the external auditors and as a group to review any significant accounting, internal control and auditing matters in accordance with the terms of the charter of the Audit Committee as set out in the Annual Information Form. The Audit Committee reviews the consolidated financial statements and Management's Discussion and Analysis before the consolidated financial statements are submitted to the Board of Directors for approval. The external auditors have free access to the Audit Committee without obtaining prior Management approval.

With respect to the external auditors, the Audit Committee approves the terms of engagement and reviews the annual audit plan, the Auditors' Report and results of the audit. It also recommends to the Board of Directors the firm of external auditors to be appointed by the shareholders.

The independent external auditors, KPMG LLP, have been appointed by the Board of Directors on behalf of the shareholders to express an opinion as to whether the consolidated financial statements present fairly, in all material respects, the Company's financial position, financial performance and cash flows in accordance with IFRS. The report of KPMG LLP outlines the scope of their examination and their opinion on the consolidated financial statements.

*/s/ Susan L. Riddell Rose*

**Susan L. Riddell Rose**

President &
Chief Executive Officer

*/s/ William A. Hahn*

**William A. Hahn**

Interim Chief Financial Officer &
Vice President, Finance

March 14, 2017

## INDEPENDENT AUDITORS' REPORT

To the Shareholders and Board of Directors of Perpetual Energy Inc.

We have audited the accompanying consolidated financial statements of Perpetual Energy Inc., which comprise the consolidated statements of financial position as at December 31, 2016 and December 31, 2015, the consolidated statements of income (loss) and comprehensive income (loss), changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

### Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as Management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by Management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Perpetual Energy Inc. as at December 31, 2016 and December 31, 2015, and its consolidated financial performance and its consolidated cash flows for the years then ended, in accordance with International Financial Reporting Standards.

*/s/ KPMG LLP*

Chartered Professional Accountants
Calgary, Canada
March 14, 2017

**PERPETUAL ENERGY INC.**
**Consolidated Statements of Financial Position**

| As at | December 31, 2016 | December 31, 2015 |
|---|---|---|
| (*Cdn$ thousands*) | | |
| **Assets** | | |
| Current assets | | |
| Cash and cash equivalents | **$ 2,877** | $ 2,116 |
| Restricted cash (note 9) | **2,000** | – |
| Accounts receivable (note 19) | **11,473** | 19,532 |
| Tourmaline Oil Corp. ("TOU") share investment (note 4) | **66,343** | 145,275 |
| Prepaid expenses and deposits | **990** | 3,141 |
| Fair value of derivatives (note 20) | **8,326** | 2,319 |
| | **92,009** | 172,383 |
| Fair value of derivatives (note 20) | **2,351** | 1,411 |
| Property, plant and equipment (note 5) | **219,886** | 347,903 |
| Exploration and evaluation (note 6) | **47,159** | 56,407 |
| Gas storage facility investment (note 7) | **–** | 25,346 |
| Total assets | **$ 361,405** | $ 603,450 |
| **Liabilities** | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | **$ 21,257** | $ 38,621 |
| Fair value of derivatives (note 20) | **9,221** | 9,353 |
| TOU share margin loans (note 10) | **39,953** | 60,059 |
| Gas over bitumen royalty financing (note 12) | **3,390** | 2,604 |
| Provisions (note 13) | **7,656** | 1,981 |
| | **81,477** | 112,618 |
| Fair value of derivatives (note 20) | **2,023** | 7,395 |
| Senior notes (note 11) | **60,120** | 271,658 |
| Gas over bitumen royalty financing (note 12) | **4,954** | 7,407 |
| Provisions (note 13) | **30,118** | 157,188 |
| Total liabilities | **178,692** | 556,266 |
| **Equity** | | |
| Share capital (note 15) | **1,327,016** | 1,297,911 |
| Shares held in trust (note 17) | **(1,311)** | (1,177) |
| Share purchase rights (note 15) | **–** | 5,290 |
| Contributed surplus | **42,999** | 38,300 |
| Deficit | **(1,185,991)** | (1,293,140) |
| Total equity | **182,713** | 47,184 |
| Total liabilities and equity | **$ 361,405** | $ 603,450 |

Subsequent events (note 8).
Commitments (note 14).

See accompanying notes to the consolidated financial statements.

*/s/ Robert A. Maitland*

**Robert A. Maitland**
Director

*/s/ Geoffrey C. Merritt*

**Geoffrey C. Merritt**
Director

**PERPETUAL ENERGY INC.**
**Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)**

| | Years Ended December 31, | |
|---|---|---|
| | **2016** | 2015 |
| (*Cdn$ thousands, except per share amounts*) | | |
| Revenue | | |
| Oil and natural gas | **$ 81,403** | $ 142,437 |
| Royalties | **(9,415)** | (16,344) |
| | **71,988** | 126,093 |
| Change in fair value of derivatives (note 20) | **18,041** | (11,437) |
| Gas over bitumen royalty credit (note 3k) | **1,984** | 3,153 |
| | **92,013** | 117,809 |
| Expenses | | |
| Production and operating | **35,019** | 65,133 |
| Transportation | **7,925** | 12,058 |
| Exploration and evaluation (note 6) | **3,790** | 10,730 |
| General and administrative | **23,064** | 21,235 |
| Gains on dispositions (notes 5 and 6) | **(27,770)** | (146,632) |
| Restructuring costs (note 13) | **5,638** | – |
| Depletion and depreciation (note 5) | **54,317** | 88,364 |
| Impairment losses (reversal) (note 5b) | **(6,900)** | 23,700 |
| **Income (loss) from operating activities** | **(3,070)** | 43,221 |
| Finance expenses (note 18) | **(24,847)** | (27,890) |
| Gain on exchange of senior notes for TOU share investment (note 11) | **81,310** | – |
| Change in fair value of TOU share investment (note 4) | **58,897** | (104,828) |
| Loss on disposition of gas storage facility investment (note 7) | **(6,165)** | – |
| Share of net income of gas storage facility investment (note 7) | **1,024** | 223 |
| **Net income (loss) and comprehensive income (loss)** | **107,149** | (89,274) |
| **Income (loss) per share (note 15)** | | |
| Basic | **$ 2.11** | $ (11.89) |
| Diluted | **$ 1.98** | $ (11.89) |

See accompanying notes to the consolidated financial statements.

**PERPETUAL ENERGY INC.**
**Consolidated Statements of Changes in Equity**

| (*Cdn$ thousands*) | Share capital (*thousands*) | Share capital (*$thousands*) | Shares held in trust | Share purchase rights | Contributed surplus | Deficit | Total equity |
|---|---|---|---|---|---|---|---|
| Balance at December 31, 2015 | 19,115 | $ 1,297,911 | $ (1,177) | $ 5,290 | $ 38,300 | $ (1,293,140) | $ 47,184 |
| Net income | – | – | – | – | – | 107,149 | 107,149 |
| Common shares issued (notes 15 and 17) | 34,566 | 29,105 | (162) | (5,290) | (1,184) | – | 22,469 |
| Change in shares held in trust (note 17) | – | – | 28 | – | (28) | – | – |
| Share based payments (note 16) | – | | | | 5,911 | – | 5,911 |
| **Balance at December 31, 2016** | **53,681** | **$ 1,327,016** | **$ (1,311)** | **$ –** | **$ 42,999** | **$(1,185,991)** | **$ 182,713** |

| (*Cdn$ thousands*) | Share capital (*thousands*) | Share capital (*$thousands*) | Shares held in trust | Share purchase rights | Equity component of convertible debentures | Contributed surplus | Deficit | Total equity |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2014 | 7,504 | $ 1,258,840 | $ (1,387) | $ – | $ 3,174 | $ 36,754 | $ (1,191,098) | $ 106,283 |
| Net loss | – | – | – | – | – | – | (89,274) | (89,274) |
| Common shares issued (notes 15 and 17) | 165 | 1,019 | 1,319 | 5,290 | – | (2,239) | (12,768) | (7,379) |
| Change in shares held in trust (note 17) | – | – | (1,109) | – | – | – | – | (1,109) |
| Share based payments (note 16) | – | – | – | – | – | 3,785 | – | 3,785 |
| Redemption of convertible debentures | 11,446 | 38,052 | – | – | (3,174) | – | – | 34,878 |
| Balance at December 31, 2015 | 19,115 | $ 1,297,911 | $ (1,177) | $ 5,290 | $ – | $ 38,300 | $ (1,293,140) | $ 47,184 |

See accompanying notes to the consolidated financial statements.

**PERPETUAL ENERGY INC.**
**Consolidated Statements of Cash Flows**

| | Year Ended December 31, 2016 | 2015 |
|---|---|---|
| (*Cdn$ thousands*) | | |
| **Cash flows from (used in) operating activities** | | |
| Net income (loss) | **$ 107,149** | $ (89,274) |
| Adjustments to add (deduct) non-cash items: | | |
| Depletion and depreciation (note 5) | **54,317** | 88,364 |
| Exploration and evaluation (note 6) | **2,727** | 6,338 |
| Share based payments (note 16) | **5,911** | 3,774 |
| Change in fair value of derivatives (note 20) | **(13,340)** | 16,063 |
| Change in fair value of TOU share investment (note 4) | **(58,897)** | 104,828 |
| Gains on dispositions (note 5a) | **(27,770)** | (146,632) |
| Finance expenses (note 18) | **10,156** | (2,756) |
| Restructuring costs (note 13) | **5,638** | – |
| Gain on exchange of senior notes for TOU share investment (note 11) | **(81,572)** | – |
| Share of net income from gas storage facility investment (note 7) | **(1,024)** | (223) |
| Loss on disposition of gas storage facility investment (note 7) | **6,165** | – |
| Impairment losses (reversal) (note 5) | **(6,900)** | 23,700 |
| Expenditures on decommissioning obligations (note 13) | **(3,803)** | (7,589) |
| Dividends from gas storage facility investment (note 7) | **501** | – |
| Payments of restructuring costs (note 13) | **(1,484)** | – |
| Change in non-cash working capital (note 19) | **(4,910)** | 15,813 |
| Net cash flows from (used in) operating activities | **(7,136)** | 12,406 |
| **Cash flows from (used in) financing activities** | | |
| Change in TOU share margin loans (note 10) | **(26,613)** | 60,230 |
| Change in gas over bitumen royalty financing (note 12) | **(2,164)** | (3,704) |
| Shares purchased and held in trust (note 17) | **(162)** | (1,109) |
| Common shares issued | **22,631** | 99 |
| Change in non-cash working capital (note 19) | **216** | – |
| Net cash flows from (used in) financing activities | **(6,092)** | 55,516 |
| **Cash flows from (used in) investing activities** | | |
| Capital expenditures | **(14,580)** | (76,341) |
| Acquisitions | **(12)** | (243) |
| Net proceeds on dispositions (note 5a) | **6,521** | 23,953 |
| Net proceeds on dispositions - marketing arrangements (note 20) | **(537)** | – |
| Net proceeds on sale of gas storage facility investment (note 7) | **19,703** | – |
| Proceeds on sale of TOU share investment (note 4) | **7,354** | 8,557 |
| Restricted cash | **(2,000)** | 6,552 |
| Change in non-cash working capital (note 19) | **(2,460)** | (39,781) |
| Net cash flows from (used in) investing activities | **13,989** | (77,303) |
| Change in cash and cash equivalents | **761** | (9,381) |
| Cash and cash equivalents, beginning of year | **2,116** | 11,497 |
| Cash and cash equivalents, end of year | **$ 2,877** | $ 2,116 |

See accompanying notes to the consolidated financial statements.

## 1. REPORTING ENTITY

Perpetual Energy Inc. (the "Company") is a Canadian corporation engaged in the exploration, development and marketing of oil and natural gas based energy in Alberta, Canada. The Company operates a diversified asset portfolio that includes liquids-rich natural gas, shallow natural gas and conventional heavy oil producing properties, as well as undeveloped bitumen resource properties.

The address of the Company's registered office is 3200, 605 – 5 Avenue S.W., Calgary, Alberta, T2P 3H5.

The consolidated financial statements of the Company are comprised of the accounts of Perpetual Energy Inc. and its wholly owned subsidiaries: Perpetual Operating Corp., Perpetual Operating Trust, and Perpetual Energy Operating Corp, which are incorporated in Canada. On October 1, 2016, the Company disposed of all the shares in Perpetual Energy Operating Corp. (note 5).

## 2. BASIS OF PREPARATION

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements of the Company were approved and authorized for issue by the Board of Directors on March 14, 2017.

The consolidated financial statements have been prepared on a historical cost basis except for the TOU share investment (note 4), TOU share margin loans (note 10), gas over bitumen royalty financing (note 12), derivative financial instruments (note 20) and share purchase rights (note 15) that have been measured at fair value. The consolidated financial statements are presented in Canadian dollars which is the functional currency of the Company and its subsidiaries.

### a) Critical accounting judgments and significant estimates

The preparation of the consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets, liabilities, revenue and expenses. These judgments, estimates, and assumptions are continuously evaluated and are based on management's experience and all relevant information available to the Company at the time of financial statement preparation. As the effect of future events cannot be determined with certainty the actual results may differ from estimates. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about the critical judgments and significant estimates made by management are described below and also in the relevant notes to the financial statements.

### b) Critical accounting judgments:

The following are the critical judgments that management has made in the process of applying the Company's accounting policies. These judgments have the most significant effect on the amounts reported in the consolidated financial statements.

i) Cash-generating units ("CGUs")

The Company allocates its oil and natural gas properties to CGUs identified as the smallest group of assets that generate cash flows independent of the cash flows of other assets or groups of assets. Determination of the CGUs is subject to management's judgement and is based on geographical proximity, shared infrastructure, and similar exposure to market risk.

ii) Identification of impairment indicators

Judgment is required to assess when impairment indicators exist and impairment testing is required. For the purposes of determining whether impairment of petroleum and natural gas assets has occurred, and the extent of any impairment or its reversal, the key assumptions the Company uses in estimating future cash flows are forecasted petroleum and natural gas prices, expected production volumes, and anticipated recoverable quantities of proved and probable reserves. These assumptions are subject to change as new information becomes available. Changes in economic conditions can also affect the rate used to discount future cash flow estimates. Changes in the aforementioned assumptions could affect the carrying amounts of assets. Impairment charges and reversals are recognized in profit or loss.

iii) Componentization

For the purposes of depletion the Company allocates its oil and natural assets to components with similar useful lives and depletion methods. The grouping of assets is subject to management's judgment and is performed on the basis of geographical proximity and similar reserve life. The Company's oil and gas assets are depleted on a unit-of-production basis.

iv) Exploration and evaluation expenditures

Costs associated with acquiring oil and natural gas licenses and exploratory drilling are accumulated as exploration and evaluation ("E&E") assets pending determination of technical feasibility and commercial viability. Establishment of technical feasibility and commercial viability is subject to judgment and involves management's review of project economics, resource quantities, expected production techniques, production costs and required capital expenditures to confirm continued intent to develop and extract the underlying resources. Management uses the establishment of commercial reserves within the exploration area as the basis for determining technical feasibility and commercial viability. Upon determination of commercial reserves, E&E assets attributable to those reserves are tested for impairment and reclassified from E&E assets to a separate category within property, plant and equipment referred to as oil and natural gas properties.

v) Joint arrangements

Judgment is required to determine when the Company has joint control over an arrangement. In establishing joint control the Company considers whether unanimous consent is required to direct the activities that significantly affect the returns of the arrangement, such as the capital and operating activities of the arrangement.

Once joint control has been established judgment is also required to classify a joint arrangement. The type of joint arrangement is determined through analysis of the rights and obligations arising from the arrangement by considering its structure, legal form, and terms agreed upon by the parties sharing control. An arrangement where the controlling parties have rights to the assets and revenues, and obligations for the liabilities and expenses, is classified as a joint operation. Arrangements where the controlling parties have rights to the net assets of the arrangement are classified as joint ventures.

**c) Significant estimates:**

The following assumptions represent the key sources of estimation uncertainty at the end of the reporting period. As future confirming events occur the actual results may differ from estimated amounts.

i) Reserves

The Company uses estimates of natural gas, oil, and natural gas liquids ("NGL" or "liquids") reserves in the calculation of depletion and also for value in use ("VIU") and fair value less costs of disposal ("FVLCD") calculations of non-financial assets. Estimates of economically recoverable natural gas, oil, and liquids reserves and their future net cash flows are based upon a number of variable factors and assumptions, such as geological, geophysical, and engineering assessments of hydrocarbons in place on the Company's lands, historical production from the properties, production rates, future commodity prices, ultimate reserve recovery, timing and amount of capital expenditures, marketability of oil and natural gas, royalty rates, the assumed effects of regulation by government agencies and future operating costs. The geological, economic and technical factors used to estimate reserves may change from period to period. Changes in the reported reserves could have a material impact on the carrying values of the Company's oil and natural gas properties, the calculation of depletion and depreciation and the timing of decommissioning cash flows.

Reserve engineers are engaged at least annually to independently evaluate or review the recoverable quantities and estimated future cash flows from the Company's interest in petroleum and natural gas properties. This evaluation of proved and proved plus probable reserves is prepared in accordance with the reserve definitions contained in National Instrument 51-101 and the COGE Handbook.

ii) Provisions for decommissioning obligations

Decommissioning, abandonment, and site reclamation expenditures for production facilities, wells and pipelines are expected to be incurred by the Company over many years into the future. Amounts recorded for decommissioning obligations and the associated accretion are calculated based on estimates of the extent and timing of decommissioning activities, future site remediation regulations and technologies, inflation, liability specific discount rates and related cash flows. The provision represents management's best estimate of the present value of the future abandonment and reclamation costs required. Actual abandonment and reclamation costs could be materially different from estimated amounts.

iii) Derivative financial instruments

Derivatives are measured at fair value on each reporting date. Fair value is the price that would be received or paid to exit the position as of the measurement date. The Company uses estimated external forward market price curves available at period end and the contracted volumes over the contracted term to determine the fair value of each contract. Changes in market pricing between period end and settlement of the derivative contracts could have a material impact on financial results related to the derivatives.

iv) Gas over bitumen royalty financing

The gas over bitumen royalty financing is measured at fair value on each reporting date. Fair value is the price that would be paid to exit the position as of the measurement date.

The fair value of the gas over bitumen royalty financing is estimated by discounting future cash payments based on the forecasted Alberta gas reference price multiplied by the contracted deemed volume. Changes in market pricing between period end and settlement could have a material impact on financial results related to the gas over bitumen royalty financing.

v) TOU share margin loans

The fair value of the TOU share margin loans are estimated using market pricing for identical financial instruments adjusted for provisions specific to the contract such as the maximum repayment amount and the notional amount of shares pledged as security. Changes in the market pricing of the shares could have a material impact on the valuation of TOU share margin loans.

## 3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these annual consolidated financial statements, and have been applied consistently by the Company, its subsidiaries, and its equity accounted gas storage facility investment.

### a) Basis of consolidation

i) Subsidiaries

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that are currently exercisable are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

ii) Business combinations

The acquisition method of accounting is used to account for acquisitions of subsidiaries and assets that meet the definition of a business under IFRS. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of acquisition of control. Identifiable assets acquired and liabilities assumed in a business combination are measured at their recognized amounts (generally fair value) at the acquisition date. The excess of the cost of acquisition over the recognized amounts of the identifiable assets acquired and liabilities assumed is recorded as goodwill. If the cost of acquisition is less than the recognized amount of the net assets acquired, the difference is recognized as a bargain purchase gain in net income or loss.

iii) Joint venture

The Company’s investment in Warwick Gas Storage Limited Partnership (“WGS LP”) was structured through a separate vehicle whereby joint control was established and the contractual arrangement provided the parties with rights to the net assets of WGS LP. The Company’s investment in WGS LP was accounted for as an investment in a jointly controlled entity using the equity-method of accounting.

On initial recognition of the investment, any excess of the Company’s share of the fair value of WGS LP’s net assets over the cost of the investment was included in the determination of the Company’s share of WGS LP’s profit or losses. The Company’s share of WGS LP’s profits or losses were recognized in net income or loss. Appropriate adjustments to the Company’s share of WGS LP profits or losses were also made to account for depreciation of assets based on their fair values at the date of initial recognition. Dividends receivable were recognized as a reduction to the carrying amount of the investment and were included in cash flows from operating activities.

An impairment loss in respect of an equity-method accounted investee is measured by comparing the recoverable amount of the investment with its carrying amount. An impairment loss is recognized in profit or loss, and is reversed if there is a favorable change in the estimates used to determine the recoverable amount.

iv) Joint operations

Many of the Company’s oil and natural gas activities involve jointly controlled operations which are not conducted through a separate vehicle. The consolidated financial statements include the Company’s proportionate share of these jointly controlled assets, liabilities, revenues and expenses.

v) Transactions eliminated on consolidation

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the consolidated financial statements.

### b) Financial instruments

Financial instruments are initially recognized at fair value on the statement of financial position. Subsequent measurement of financial instruments is based on their initial classification into one of the following categories: financial assets and liabilities measured at fair value through profit or loss, loans and receivables, held to maturity investments, available-for-sale financial assets, or other financial liabilities.

Financial instruments presented in the statement of financial position are shown net of offsetting assets or liabilities where the arrangement provides or the legal right and intention for net settlement exists.

i) Financial assets

| Financial Instrument | Category | Subsequent Measurement |
|---|---|---|
| Accounts receivable | Loans and receivables | Amortized cost |
| TOU share investment | Financial assets | Fair value through profit or loss |

The Company's accounts receivable are initially recognized on the date they originate and are measured at amortized cost using the effective interest method, less any impairment losses.

The TOU share investment is a non-derivative financial instrument measured at fair value through profit or loss ("FVTPL") as the Company manages such investments and makes decisions based on their fair value in accordance with the Company's risk management or investment strategy.

ii) Financial liabilities

| Financial Instrument | Category | Subsequent Measurement |
|---|---|---|
| Accounts payable and accrued liabilities | Financial liabilities | Amortized cost |
| Bank indebtedness | Financial liabilities | Amortized cost |
| Senior notes | Financial liabilities | Amortized cost |
| Gas over bitumen royalty financing | Financial liabilities | Fair value through profit or loss |
| TOU share margin loans | Financial liabilities | Fair value through profit or loss |

Accounts payable and accrued liabilities, bank indebtedness and senior notes are recognized initially at fair value and are subsequently measured at amortized cost using the effective interest method.

iii) Derivative assets and liabilities

The Company has entered into certain financial derivative contracts in order to manage the exposure to market risks from fluctuations in commodity prices and currency rates. The Company has not designated its financial derivative contracts as effective accounting hedges, and thus not applied hedge accounting, even though the Company considers all commodity and currency contracts to be economic hedges. As a result, all financial derivative contracts are designated as fair value through profit or loss and recorded as derivatives on the statement of financial position at fair value. Changes in the fair value of the commodity price and currency rate derivatives are recognized in net income or loss.

The Company has accounted for its forward physical delivery fixed-price sales contracts as derivative financial instruments. Accordingly, such forward physical delivery fixed-price sales contracts are designated as fair value through profit or loss and recorded as derivatives on the statement of financial position at fair value.

Transaction costs on derivatives are recognized in net income or loss when incurred.

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and the combined instrument is not measured at fair value through profit or loss. Changes in the fair value of separable embedded derivatives are recognized immediately in net income or loss.

iv) Share capital

Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

**c) Property, plant and equipment**

i) Production and development costs

Items of property, plant and equipment, which include oil and natural gas development and production assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses. The initial cost of property, plant and equipment includes the purchase price or construction costs, costs that are directly attributable to bringing the asset into commercial operations, the initial estimate of decommissioning costs, and borrowing costs for qualifying assets.

Significant parts of an item of property, plant and equipment, including oil and natural gas properties, that have different useful lives from the life of the area or facility in general, are accounted for as separate items.

Gains and losses on disposition of an item of property, plant and equipment, including oil and natural gas properties, are determined by comparing the proceeds from disposition with the carrying amount of property, plant and equipment and are recognized in net income or loss. The carrying amount of any replaced or disposed item of property, plant and equipment is derecognized.

ii) Subsequent costs

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property, plant and equipment are recognized as property, plant and equipment only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in net income or loss as incurred. Such capitalized property, plant and equipment generally represent costs incurred in developing proved and/or probable reserves and bringing on or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The costs of the day-to-day servicing of property, plant and equipment are recognized in net income or loss as incurred.

iii) Depletion and depreciation

The net carrying amount of development or production assets is depleted using the unit-of-production method by reference to the ratio of production in the period to the related proved and probable reserves, taking into account estimated future development costs necessary to bring those reserves into production and future decommissioning costs. Future development and decommissioning costs are estimated taking into account the level of development required to produce the reserves. The future development cost estimates are reviewed by independent reserve engineers at least annually.

Costs associated with office furniture, information technology, and leasehold improvements are carried at cost and are depreciated on a straight line basis over a period ranging from one to three years.

Costs associated with abandonment equipment and turnaround equipment at major facilities are carried at cost and are depreciated on a straight line basis over a period ranging from five to seven years.

Depreciation methods, useful lives and residual values are reviewed at each period end date for all classes of property, plant, and equipment.

**d) Exploration and evaluation expenditures**

Pre-license costs, geological and geophysical costs and lease rentals of undeveloped properties are recognized in net income or loss as incurred.

E&E costs, consisting of the costs of acquiring oil and natural gas licenses, are capitalized initially as E&E assets according to the nature of the assets acquired. Costs associated with drilling exploratory wells in an undeveloped area are capitalized as E&E costs. The costs are accumulated in cost centers by well, field or exploration area pending determination of technical feasibility and commercial viability. When technical feasibility and commercial viability are determined, the relevant expenditure is transferred to oil and gas properties after impairment is assessed and any applicable impairment loss is recognized in net income or loss.

The Company's E&E assets consist of undeveloped land, exploratory drilling assets, and bitumen evaluation assets. Gains and losses on disposition of E&E assets are determined by comparing the proceeds from disposition with the carrying amount and are recognized in net income or loss.

**e) Assets held for sale**

Non-current assets, or disposal groups consisting of assets and liabilities ("disposal groups"), are classified as held for sale if their carrying amounts will be recovered principally through a sale transaction rather than through continuing use. Assets and liabilities qualifying as held for sale must be available for immediate sale in their present condition subject to normal terms and conditions and their sale must be highly probable.

Non-current assets, or disposal groups, are measured at the lower of the carrying amount and fair value less costs of disposal, with impairments recognized in net income or loss. Non-current assets or disposal groups held for sale are presented in current assets and liabilities within the statement of financial position. Assets held for sale are not subject to depletion and depreciation.

**f) Impairment**

i) Financial assets

Financial assets are assessed at each period end date to determine whether there is any objective evidence that they are impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in net income or loss. An impairment loss is reversed when there is objective evidence that the value of the financial asset has been partially or fully restored. For financial assets measured at amortized cost the reversal is recognized in net income or loss.

ii) Non-financial assets

The carrying amounts of the Company's non-financial assets, other than E&E assets, are reviewed at each period end date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. E&E assets are assessed for impairment when they are reclassified to property, plant and equipment, as oil and natural gas properties, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together at a CGU level. The recoverable amount of an asset or a CGU is determined based on the higher of its FVLCD and its VIU. FVLCD is determined as the amount that would be obtained from the sale of a CGU in an arm's length transaction between knowledgeable and willing parties. The FVLCD of oil and gas properties is generally determined as the net present value of estimated future cash flows expected to arise from the continued use of the CGU and its eventual disposition, using assumptions that an independent market participant may take into account. These cash flows are discounted by an appropriate discount rate which would be applied by such a market participant to arrive at a net present value of the CGU. In determining value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. VIU is generally determined by reference to the present value of the future cash flows expected to be derived from production of proved and probable reserves.

E&E assets are assessed for impairment both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to oil and natural gas properties in property, plant and equipment. If a test is required as a result of triggering facts and circumstances, the Company considers whether the combined recoverable amount of oil and natural gas properties and E&E assets at the total company level is sufficient to cover the combined carrying value of E&E and oil and natural gas assets.

An impairment loss is recognized if the carrying amount of an asset or its CGU, including the related decommissioning obligation, exceeds its estimated recoverable amount. Impairment losses recognized in respect of CGUs are allocated to reduce the carrying amount of assets in the unit (group of units) on a pro rata basis. Impairment losses are recognized in net income or loss.

In respect of other assets, impairment losses recognized in prior years are assessed at each period end date for any indication that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation, if no impairment loss had been recognized.

### g) Shares held in trust

The Company has a compensation program whereby employees may be entitled to receive shares of the Company purchased on the open market by a trustee controlled by the Company. Shares acquired and held by the trustee for the benefit of employees that have not yet been issued to employees are presented as a separate category of equity. The balance of shares held in trust represents the cumulative cost of shares held by the trustee. Upon the issuance of shares to the employee, the amount attributable to an employee is deducted from the balance of shares held in trust and transferred to contributed surplus.

### h) Share based payments

Awards granted under share based payment plans and agreements are equity-settled and are measured at grant-date fair value. Fair values are determined by means of an option pricing model using the exercise price of the equity instrument granted, the share price at the grant date, the expected life of the grant based on the vesting date and expiry date, estimates of volatility and interest rates over its expected life. A forfeiture rate is estimated on the grant date and is subsequently adjusted to reflect the actual number of options that vest.

The costs of the equity-settled share based payments are recognized within general and administrative expenses, or property, plant and equipment to the extent they are directly attributable, with a corresponding increase in contributed surplus over the vesting period. Upon exercise or settlement of an equity-based instrument, consideration received and associated amounts previously recorded in contributed surplus are recorded to share capital.

### i) Flow-through shares

Periodically, the Company finances a portion of its exploration and development activities through the issuance of flow through shares. Resource expenditure deductions for income tax purposes related to exploratory development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. Flow-through shares issued are recorded in share capital at the fair value of common shares on the date of issue. The premium received on issuing flow-through shares is initially recorded as a deferred liability. As qualifying expenditures are incurred, the premium is reversed and a deferred income tax liability is recorded. The net amount is then recognized as deferred income tax expense.

### j) Provisions

Provisions are recognized when the Company has a current legal or constructive obligation as a result of a past event, which can be reliably estimated, and will require the outflow of economic resources to settle the obligation. A non-current provision is determined using the estimated future cash flows discounted at a rate that reflects current market conditions and liability specific risks.

i) Decommissioning obligations

The Company's activities give rise to dismantling, decommissioning and site disturbance remediation activities. A provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning obligations are measured at the present value of management's estimate of expenditures required to settle the present obligation at the statement of financial position date and using a risk free interest rate not adjusted for credit risk. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time, changes in the estimated future cash flows underlying the obligation and changes in the risk free rate. The accretion of the provision due to the passage of time is recognized in net income or loss whereas changes in the provision arising from changes in estimated cash flows or changes in the risk free rate are capitalized. Actual costs incurred upon settlement of the decommissioning obligations are charged against the provision to the extent the provision was established.

ii) Restructuring provisions

Restructuring provisions are recognized when the Company has developed a detailed formal plan for restructuring and has announced the plan's main features to those affected by it. The measurement of a restructuring provision includes only the direct expenditures arising from the restructuring, which are those amounts that are not associated with the ongoing activities of the Company.

A provision for onerous contracts is recognized when the expected benefits to be derived by the Company from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

A provision for employee downsizing costs is recognized when the Company has announced the restructuring plan to those affected by it, and can no longer withdraw the offer of those benefits. The provision is measured on initial recognition at the Company's best estimate of the expenditure required to settle the obligation.

### k) Revenue

Revenue and royalty expense from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product are transferred to the buyer which is usually when legal title passes to the external party. This is generally at the time product enters a third party transmission pipeline.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

The Company's entitlement to gas over bitumen royalty adjustments under the Natural Gas Royalty Regulation (2004) with respect to foregone production (deemed production) from gas wells shut-in for the benefit of bitumen producers in the Athabasca oil sands area, is recognized as gas over bitumen revenue in the period that deemed production occurs, to the extent that they are expected to be recovered through gas Crown royalties otherwise payable.

### l) Income tax

Income tax expense comprises current and deferred components. Income tax expense is recognized in net income or loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the period end date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the period end date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each period end date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

### m) Income or loss per share amounts

Basic income or loss per share is calculated by dividing the net income or loss by the weighted average number of common shares outstanding during the period. For the dilutive net income or loss per share calculation, the weighted average number of shares outstanding is adjusted for the potential number of shares which may have a dilutive effect on net income or loss.

Diluted income or loss per share is calculated giving effect to the potential dilution that would occur if outstanding Share Options, Restricted Rights, or Performance Share Units, were exercised or converted into common shares. The weighted average number of diluted shares is calculated in accordance with the treasury stock method for Share Options, Restricted Rights and Performance Share Units and the if-converted method for potentially issuable common shares through the convertible debentures. The treasury stock method assumes that the proceeds received from the exercise of all potentially dilutive instruments are used to repurchase common shares at the average market price. The if-converted method assumes conversion of convertible securities at the beginning of the reporting period.

## n) Recent pronouncements issued

The Company will be required to adopt the following new standards and amendments as issued by the IASB. The Company is currently evaluating the impact on the consolidated financial statements as discussed below.

i) In April 2016, the IASB issued its final amendments to IFRS 15, "Revenue from Contracts with Customers", which replaces IAS 18 "Revenue", IAS 11 "Construction Contracts", and related interpretations. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers. The standard requires an entity to recognize revenue to reflect the transfer of goods and services for the amount it expects to receive, when control is transferred to the purchaser. Disclosure requirements have also been expanded. The standard is required to be adopted either retrospectively or using a modified retrospective approach for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. IFRS 15 will be applied by Perpetual on January 1, 2018. The Company is currently in the process of reviewing its various revenue streams and underlying contracts with customers to determine the impact, if any, that the adoption of IFRS 15 will have on its financial statements, as well as the impact that adoption of the standard will have on disclosure.

ii) In July 2014, the IASB completed the final elements of IFRS 9, "Financial Instruments". The standard supersedes earlier versions of IFRS 9 and completes the IASB's project to replace IAS 39 "Financial Instruments: Recognition and Measurement". IFRS 9 introduces a single approach to determine whether a financial asset is measured at amortized cost or fair value and replaces the multiple rules in IAS 39. The approach is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. For financial liabilities, IFRS 9 retains most of the requirements of IAS 39; however, where the fair value option is applied to financial liabilities, any change in fair value resulting from an entity's own credit risk is recorded in OCI rather than the statement of income, unless this creates an accounting mismatch. In addition, IFRS 9 introduces a new expected credit loss model for calculating impairment of financial assets, replacing the incurred loss impairment model required by IAS 39. Perpetual does not anticipate that the new impairment model will result in material changes to the valuation of its financial assets on adoption of IFRS 9. IFRS 9 also contains a new model to be used for hedge accounting. The Company does not currently apply hedge accounting to its risk management contracts and does not currently intend to apply hedge accounting to any of its existing risk management contracts on adoption of IFRS 9. The standard will come into effect for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. IFRS 9 will be applied on a retrospective basis by Perpetual on January 1, 2018.

iii) IFRS 16, "Leases" was issued in January 2016 and replaces IAS 17 "Leases". Under the new standard, a single recognition and measurement model for leases is introduced which would require the recognition of most leases with a term greater than twelve months on the statement of financial position. The new standard is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted for entities that apply IFRS 15 "Revenue from Contracts with Customers" at or before the initial adoption date of January 1, 2018. IFRS 16 will be applied by Perpetual on January 1, 2019 and the Company is currently evaluating the impact of the standard on the financial statements.

## 4. TOU SHARE INVESTMENT

| | **December 31, 2016** | | December 31, 2015 | |
|---|---|---|---|---|
| | **Shares *(thousands)*** | **Amount *($thousands)*** | Shares *(thousands)* | Amount *($thousands)* |
| Balance, beginning of year | **$ 6,500** | **$ 145,275** | $ – | $ – |
| Acquired in sale of west Edson assets (note 5a) | **–** | **–** | 6,750 | 258,660 |
| Sold | **(250)** | **(7,354)** | (250) | (8,557) |
| Exchange for senior notes (note 11) | **(4,403)** | **(130,475)** | – | – |
| Unrealized change in fair value | **–** | **58,897** | – | (104,828) |
| Balance, end of year | **$ 1,847** | **$ 66,343** | $ 6,500 | $ 145,275 |

On April 1, 2015, the Company received 6.75 million common shares of Tourmaline Oil Corp. ("TOU"), valued at $258.7 million in exchange for the Company's West Edson asset (note 5a).

TOU is engaged in the acquisition, exploration, development and production of petroleum and natural gas properties situated in western Canada. TOU shares are listed on the Toronto Stock Exchange under the trading symbol "TOU".

During the second quarter of 2016, 4.4 million TOU shares valued at $130.5 million were exchanged for the Company's senior notes (note 11).

At December 31, 2016, the Company held 1.85 million (December 31, 2015 – 6.5 million) TOU shares with a fair market value of $66.3 million (December 31, 2015 - $145.3 million) based on a December 31, 2016 closing price of $35.91 per share (December 31, 2015 - $22.35). Net income for the year ended December 31, 2016 includes an unrealized gain of $58.9 million (2015 – loss of $104.8 million) representing the change in fair value of TOU shares held during the year.

Subsequent to December 31, 2016, the Company sold 180,000 TOU shares for net cash proceeds of $5.7 million (note 10).

At December 31, 2016, 1.5 million TOU shares (December 31, 2015 – 6.5 million TOU shares) were pledged as security for the TOU share margin loans (note 10).

As at December 31, 2016, a $1.00 per share increase in the market price of TOU shares would increase the Company's after tax net income by $1.8 million. The TOU share margin loans detailed in note 10 include put options that effectively protect the Company from potential TOU share price decreases on 0.84 million TOU shares below $27.72 per share and 0.65 million TOU shares below $27.38 per share.

## 5. PROPERTY, PLANT AND EQUIPMENT

| | Oil and Gas Properties | Corporate Assets | Total |
|---|---|---|---|
| **Cost** | | | |
| December 31, 2014 | $ 2,633,900 | $ 7,021 | $ 2,640,921 |
| Additions | 69,086 | 69 | 69,155 |
| Non-monetary additions | 3,700 | – | 3,700 |
| Change in decommissioning obligations (note 13) | (58,313) | – | (58,313) |
| Transfers from exploration and evaluation (note 6) | 692 | – | 692 |
| Acquisitions | 3 | – | 3 |
| Dispositions | (218,500) | – | (218,500) |
| December 31, 2015 | 2,430,568 | 7,090 | 2,437,658 |
| Additions | 14,170 | 92 | 14,262 |
| Change in decommissioning obligations (note 13) | 5,213 | – | 5,213 |
| Dispositions | (1,838,905) | – | (1,838,905) |
| **December 31, 2016** | **$ 611,046** | **$ 7,182** | **$ 618,228** |
| **Accumulated depletion, depreciation and impairment losses** | | | |
| December 31, 2014 | $ (2,072,642) | $ (6,323) | $ (2,078,965) |
| Depletion and depreciation | (88,067) | (297) | (88,364) |
| Dispositions | 105,096 | – | 105,096 |
| Impairment | (27,522) | – | (27,522) |
| December 31, 2015 | (2,083,135) | (6,620) | (2,089,755) |
| Depletion and depreciation | (54,034) | (283) | (54,317) |
| Dispositions | 1,738,830 | – | 1,738,830 |
| Impairment reversal | 6,900 | – | 6,900 |
| **December 31, 2016** | **$ (391,439)** | **$ (6,903)** | **$ (398,342)** |
| **Carrying amount** | | | |
| December 31, 2015 | $ 347,433 | $ 470 | $ 347,903 |
| **December 31, 2016** | **$ 219,607** | **$ 279** | **$ 219,886** |

At December 31, 2016, property, plant and equipment included $1.4 million (December 31, 2015 – $6.1 million) of costs currently not subject to depletion.

Future development costs for the year ended December 31, 2016 of $367.6 million (December 31, 2015 - $458.7 million) were included in the depletion calculation.

### a) Dispositions

| | Year ended December 31, **2016** | 2015 |
|---|---|---|
| Net cash proceeds | **$ 6,521** | $ 23,953 |
| Non-cash proceeds | **–** | 268,240 |
| Property, plant and equipment after net accumulated DD&A | **(100,075)** | (113,404) |
| Exploration and evaluation (note 6) | **(6,851)** | (34,096) |
| Decommissioning obligations (note 13) | **129,602** | 1,939 |
| Marketing arrangements related to shallow gas property disposition | **(3,184)** | – |
| Realized/unrealized changes to retained marketing arrangements | **1,757** | – |
| Gain on dispositions | **$ 27,770** | $ 146,632 |

During the year ended December 31, 2016, the Company received net cash proceeds of $6.5 million (2015 - $24.0 million) from dispositions which were attributed to certain oil sands leases, non-core undeveloped lands, seismic data and idle production equipment.

On October 1, 2016, the Company disposed of a significant portion of the Company's shallow gas properties in east central and northeast Alberta (the "Shallow Gas Properties") for nominal cash consideration and the assumption of $128.0 million of decommissioning obligations associated with the Shallow Gas Properties, resulting in a gain on disposition of $19.2 million. In addition, the transaction included marketing arrangements (described below) whereby the Company will receive additional consideration to the extent natural gas average monthly AECO prices exceed $2.81/GJ on 33,611 GJ/d through to August 31, 2018. Additionally, the Company has retained price exposure on 33,611 GJ/d to the extent average monthly AECO prices fall below $2.58/GJ for the April 2018 through August 2018 period.

Realized and unrealized gains and losses on these marketing arrangements are recognized as adjustments to gains/losses on dispositions. During the fourth quarter, $1.8 million of realized and unrealized net gains were recorded with respect to these arrangements.

At December 31, 2016, the retained shallow gas marketing arrangements has been summarized as follows:

| Term | Volumes at AECO (*GJ/d*) | Floor price (*$CAD/GJ*) | Ceiling price (*$CAD/GJ*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 – August 2018 | 33,611 | – | 2.81 | 4,811 |
| April 2018 – August 2018 | 33,611 | 2.58 | – | (1,002) |

On April 1, 2015, the Company sold its joint interest share in its West Edson assets in West Central Alberta in exchange for 6.75 million TOU shares. Non-monetary gross proceeds of $258.7 million were calculated based on the market value of the TOU shares determined using the April 1, 2015 closing price on the Toronto Stock Exchange.

The Company undertook additional property transactions throughout 2015 including the disposition of certain fee simple lands in east central Alberta and related seismic data, for net cash proceeds of $21.0 million. The Company also disposed of its interest in certain non-core undeveloped lands for cash proceeds of $1.2 million and executed an asset swap to acquire an increased interest in existing reserves as well as undeveloped acreage in its core East Edson property in exchange for its working interest in certain undeveloped lands and net cash proceeds of $1.8 million.

**b) Cash-generating units, impairments and reversals**

For the year ended December 31, 2016, the Company conducted an assessment of impairment indicators for the Company's CGUs. In performing the review, management determined that the disposition of the Shallow Gas Properties justified calculation of the recoverable amount of the Athabasca CGUs (renamed Northern CGU). In addition, technical revisions to Mannville heavy oil reserves related to improved recovery methods along with realized lower operating and capital efficiencies justified a review for impairment reversals for the Birchwavy East CGU (renamed Eastern CGU). The Company determined the recoverable amount of Northern and Eastern CGUs using VIU based on the net present value of cash flows from oil, natural gas, and NGL reserves using estimates of total proved plus probable reserves evaluated or reviewed by the Company's independent reserves evaluators along with the associated year-end commodity price forecast, and an estimate of market discount rates between 12 and 20 percent to consider risks specific to the asset.

At December 31, 2016, the Company recorded a net impairment reversal of $6.9 million to net income which was comprised of the following:

- The Company determined that the carrying amount of the Northern CGU exceeded the recoverable amounts. Accordingly, an impairment charge of $5.8 million was included in net income; and
- The Company determined that the recoverable amount of the Eastern CGU exceeded its carrying amount by $15.9 million; accordingly, a reversal of $12.7 million was recognized in net income representing the full reversal of previously recorded impairments adjusted for depletion.

The independent reserves evaluator's commodity price estimates were used in the VIU calculations as at December 31, 2016:

| Year | WTI Crude Oil (*US$/bbl*) | USD/CDN exchange rate (*US$/Cdn$*) | Alberta heavy crude oil (*Cdn$/bbl*) | AECO natural gas (*Cdn$/mmbtu*) |
|---|---|---|---|---|
| 2017 | 55.00 | 0.75 | 46.50 | 3.40 |
| 2018 | 58.70 | 0.78 | 50.50 | 3.15 |
| 2019 | 62.40 | 0.80 | 54.00 | 3.30 |
| 2020 | 69.00 | 0.83 | 58.00 | 3.60 |
| 2021 | 75.80 | 0.85 | 61.90 | 3.90 |
| 2022 | 77.30 | 0.85 | 63.10 | 3.95 |
| 2023 | 78.80 | 0.85 | 64.40 | 4.10 |
| 2024 | 80.40 | 0.85 | 65.60 | 4.25 |
| 2025 | 82.00 | 0.85 | 67.00 | 4.30 |
| 2026 | 83.70 | 0.85 | 68.40 | 4.40 |
| 2027 | 85.30 | 0.85 | 69.60 | 4.50 |
| 2028 | 87.00 | 0.85 | 71.10 | 4.60 |
| 2029 | 88.80 | 0.85 | 72.50 | 4.65 |
| 2030 | 90.60 | 0.85 | 74.00 | 4.75 |
| 2031 | 92.40 | 0.85 | 75.40 | 4.85 |

Escalate 2.0 percent per year thereafter

At December 31, 2015, management determined that the recent declines in commodity pricing and the impact these declines have on the economic performance of the Company justified calculation of the recoverable amount for all CGUs. The Company determined that the carrying amount of the Birchwavy East and Birchwavy West CGUs exceeded their recoverable amounts using similar methodology, sources of inputs and discount rates as were used at December 31, 2016. Accordingly, an impairment charge of $9.0 million was included in net income. 2015 impairment losses also included $14.7 million related to de-recognition of the Company's gas over bitumen CGU, comprised of $18.5 million related to the carrying amount of property, plant and equipment offset by a $3.8 million reduction of the gas over bitumen provision for estimated future repayments of gas over bitumen credits received.

## 6. EXPLORATION AND EVALUATION

| | 2016 | 2015 |
|---|---|---|
| Balance, beginning of year | **$ 56,407** | $ 84,227 |
| Additions | **318** | 7,186 |
| Acquisitions | **12** | 240 |
| Dispositions (note 5a) | **(6,851)** | (34,096) |
| Non-cash exploration and evaluation expense | **(2,727)** | (6,338) |
| Non-monetary additions | **–** | 5,880 |
| Transfers to property, plant and equipment (note 5) | **–** | (692) |
| Balance, end of year | **$ 47,159** | $ 56,407 |

During the year ended December 31, 2016, the Company disposed of $6.9 million in undeveloped lands mainly in connection with the disposition of the Shallow Gas Properties (note 5a).

During the year ended December 31, 2016, $1.1 million (2015 – $4.4 million) in costs were charged directly to E&E expense in net income (loss).

## 7. GAS STORAGE FACILITY INVESTMENT

The Company owned a 30 percent partnership interest in the WGS LP gas storage facility located in Alberta, Canada that was accounted for using the equity-method.

On May 25, 2016, the Company disposed of its interest in WGS LP for net cash proceeds of $19.7 million, resulting in a net loss on disposition of $6.2 million.

Prior to the disposition, transactions between the Company and WGS LP totaled $0.6 million in 2016 (2015 - $1.6 million) consisting primarily of fees earned for the provision of management and operational services. This service agreement between the Company and WGS LP was terminated concurrent with the disposition. The Company received dividends of $0.5 million which were declared and received by WGS LP prior to the disposition (2015 - nil).

Summary financial information for the Company's equity method gas storage facility investment is as follows:

| **For the period ended** | **May 25, 2016** | December 31, 2015 |
|---|---|---|
| Revenue | **$ 6,756** | $ 10,251 |
| Depreciation | **(1,398)** | (3,440) |
| Other expenses | **(2,511)** | (9,881) |
| Unrealized gain (loss) on gas storage obligation derivative | **623** | 4,023 |
| Net income (loss) | **3,470** | 953 |
| Share of net income (loss) | **1,041** | 286 |
| Amortization of fair value adjustment on acquisition of interest in WGS LP | **(17)** | (63) |
| **Share of net income (loss) of equity method investment** | **$ 1,024** | $ 223 |

## 8. CAPITAL MANAGEMENT

The Company's goal is to maintain a strong capital base so as to retain investor, creditor and market confidence and to support the execution of the Company's business plan. The Company manages its capital structure and makes adjustments to its capital spending in light of changes in economic conditions and the risk characteristics of its underlying oil and natural gas assets. The Company considers its capital structure to include share capital, senior notes, bank indebtedness, TOU share margin loans and net working capital (note 9), with value and liquidity enhanced through the current ownership of TOU shares.

With the deterioration of commodity prices continuing in 2016, the Company was focused on liquidity management and preservation of its balance sheet by restricting capital spending, reducing costs and maximizing efficiencies in administration and operations. A diligent focus on reductions in all areas of spending, including operating, financing and administrative costs, will continue in order to establish a sustainable cost structure in this low commodity price environment.
At December 31, 2016, the majority of the Company's debt is in the form of senior notes with maturities in 2018 and 2019. Obligations which will require settlement or extension in 2017 include the reserve based credit facility on April 28, 2017 and two TOU share margin loans maturing March 14, 2017 and November 16, 2017 which can be repaid in cash or through settlement with the TOU shares pledged as security.

Subsequent to December 31, 2016, the Company completed a number of financing transactions to strengthen Perpetual's liquidity and debt repayment profile and secure funding for the Company's 2017 and 2018 business plan. The significant financing transactions are as follows:

- Partial repayment and refinancing of its existing TOU share put option margin loan previously maturing in March 2017, reducing the loan amount outstanding to $18.9 million, extending the maturity to August 1, 2017 and increasing the number of shares pledged as collateral to 0.9 million TOU shares, with a new floor price on these shares of $21.14 per TOU share (note 10);
- Exchange of $17.4 million aggregate principal amount of its existing senior notes maturing in 2018 and 2019 for new 8.75% senior notes having an extended maturity date of January 23, 2022 (the "2022 Senior Notes") (note 11);

- Establishment of a $45 million second lien senior secured term loan facility (the "Second Lien Facility") bearing annual interest at 8.1 percent and maturing March 14, 2021. The initial draw on the Second Lien facility was $35 million with the remaining $10 million to be drawn prior to November 30, 2017. In addition, for no additional consideration, 5.4 million warrants were issued which entitle the holder to acquire common shares on a one for one basis for a period of up to three years, at an exercise price of $2.34 per share, equal to a 45 percent premium to the volume weighted average trading price of the common shares for the ten trading days prior to the date of issue of the warrants on March 14, 2017;
- Issuance of 5.1 million common shares and 1.1 million warrants to purchase common shares on the same terms and conditions as above (collectively, the "Equity Units") at $1.75 per Equity Unit for aggregate gross proceeds of $9 million. Included in the issuance were 1.6 million common shares and 0.4 million warrants issued to directors and officers of the Company or entities controlled by them, for proceeds of $2.9 million (note 15);
- Extension of the Company's current bank lending arrangements to October 31, 2017, while providing for a $14 million increase in total borrowing capacity under the credit facility to $20 million (note 9); and
- Issuance of a notice for the early redemption of all of the $27.6 million aggregate outstanding principal amount of its 8.75% senior notes maturing March 15, 2018, effective April 15, 2017. The redemption amount payable will be either: CDN $1,000 for each $1,000 principal amount of 2018 Senior Notes; or at the election of an eligible holder and subject to the limitations described in the notice, $1,000 principal amount of 2022 Senior Notes for each $1,000 principal amount of 2018 Senior Notes.

The Company will continue to regularly assess changes to its capital structure and repayment alternatives, with considerations for both short term liquidity and longer term financial sustainability.

## 9. BANK INDEBTEDNESS

As at December 31, 2016, the Company had a reserve based, revolving credit facility (the "Credit Facility") with a borrowing limit (the "Borrowing Limit") of $6.0 million (2015 - $20.0 million) under which $4.0 million of letters of credit had been drawn (2015 - $5.4 million). The Credit Facility matures on April 28, 2017. Borrowings under the Credit Facility bear interest at its lenders' prime rate or Banker's Acceptance rates, plus applicable margins and standby fees. The applicable margins range between 1.25% and 4.75%. Borrowings are secured by general security agreements covering all of the Company's assets with the exception of TOU shares pledged as security for the TOU share margin loans (note 10) and certain lands pledged to the gas over bitumen royalty financing counterparty (note 12). As at December 31, 2016, the Company had pledged restricted cash of $2.0 million in favor of its lender as additional security.

The Credit Facility is subject to a working capital covenant which requires the Company to maintain net working capital plus outstanding letters of credits to not exceed the Borrowing Limit. Net working capital includes the sum of cash and cash equivalents, restricted cash, accounts receivable, prepaid expenses and unpledged TOU shares less accounts payable and accrued liabilities and accrued interest on senior notes up to the Credit Facility maturity date. The Company was in compliance with all Credit Facility covenants at December 31, 2016.

The credit facility also contains provisions which restrict the Company's ability to pay dividends on or repurchase its common shares.

On February 8, 2017, the Company's lender released the restricted cash and on March 8, 2017, increased the Credit Facility Borrowing Limit to $20.0 million and extended its maturity to October 31, 2017. The next Borrowing Limit redetermination will occur on or before May 31, 2017.

## 10. TOU SHARE MARGIN LOANS

| | Years ended December 31, | |
|---|---|---|
| | **2016** | 2015 |
| TOU share put option margin loans | **$ 39,953** | $ 18,059 |
| TOU margin loans | **–** | 42,000 |
| Total TOU share margin loans | **$ 39,953** | $ 60,059 |

At December 31, 2016, the Company has TOU share margin loans with two lenders for which TOU shares have been pledged as collateral. Under these TOU share margin loans, the Company effectively purchased embedded TOU put options from the lender ("TOU share put option margin loans"). TOU share put option margin loans bear interest based on fixed interest rates, plus the cost of purchasing the embedded TOU put option, if applicable.

At December 31, 2016, $23.2 million (December 31, 2015 - $18.1 million) TOU share put option margin loans mature in March 2017 and $16.8 million (December 31, 2015 – nil) mature in November 2017. For the March 2017 maturity, 0.84 million (December 31, 2015 – 1.0 million) TOU shares have been pledged as collateral with a put option floor price of $27.72 per share (December 31, 2015 – $21.32 per share). For the November 2017 maturity, 0.65 million TOU shares have been pledged as collateral with a put option floor price of $27.38 per share.

At December 31, 2015, 5.5 million TOU shares had been pledged as collateral for the $42.0 million TOU margin loans. The TOU margin loans bear interest based on floating interest rates.

The TOU share put option margin loans are hybrid financial instruments comprising a debt host with an embedded TOU put option derivative related to indexation of the future settlement amount to changes in the market price of TOU shares pledged as collateral. The Company has designated the TOU share put option margin loans as financial liabilities which are measured at fair value through profit and loss. For the year ended December 31, 2016, an unrealized loss of $6.5 million (December 31, 2015 – unrealized gain of $0.2 million) is included in finance expense, representing the change in fair value of the TOU put options during the year.

Subsequent to December 31, 2016, the Company sold 180,000 TOU shares for net cash proceeds of $5.7 million which was applied as a reduction to the TOU share put option margin loan set to expire in March 2017. The remaining balance was extended to August 1, 2017 subject to a maximum payment of $18.9 million at maturity. The number of shares pledged as collateral was increased to 0.9 million with the floor price being reset to $21.14 per TOU share.

## 11. SENIOR NOTES

| | | | **December 31, 2016** | | December 31, 2015 | |
|---|---|---|---|---|---|---|
| | **Maturity date** | **Interest rate** | **Principal** | **Carrying Amount** | Principal | Carrying amount |
| 2018 senior notes | March 15, 2018 | 8.75% | $ 36,013 | $ 35,847 | $ 150,000 | $ 148,724 |
| 2019 senior notes | July 23, 2019 | 8.75% | 24,560 | 24,273 | 125,000 | 122,934 |
| | | | $ 60,573 | $ 60,120 | $ 275,000 | $ 271,658 |

During the second quarter of 2016, the Company repurchased and cancelled $114.0 million of outstanding 2018 Senior Notes and $100.4 million of outstanding 2019 Senior Notes through the exchange of 4.4 million TOU shares and cash payments of $3.9 million for accrued interest (the "Security Swap"). The fair market value of TOU shares exchanged was $130.5 million based on an average closing price of $29.64 per share. Included in the exchange were $81.6 million 2018 Senior Notes and $57.0 million 2019 Senior Notes held by directors and officers of the Company or entities controlled by them. The Company recorded a net gain on the Security Swap of $81.3 million, representing the difference between the carrying amount of senior notes cancelled of $212.0 million ($214.4 million principal amount) and the fair market value of TOU shares exchanged of $130.5 million, net of transaction costs.

On January 23, 2017, the Company exchanged $8.4 million and $9.0 million aggregate principal amount of 2018 Senior Notes and 2019 Senior Notes respectively for $17.4 million new 8.75% senior notes with a maturity date of January 23, 2022. Included in the exchange were $3.7 million 2018 Senior Notes and $4.3 million 2019 Senior Notes held by directors and officers of the Company or entities controlled by them. The 2022 Senior Notes bear a fixed rate of 9.75% for the first year of issuance and 8.75% thereafter, and have identical covenants and rights as the existing 2018 and 2019 Senior Notes. After giving effect to the exchange, outstanding senior notes are as follows:

| | **Maturity date** | **Interest rate[(1)]** | **Payment dates** | **Principal** |
|---|---|---|---|---|
| 2018 senior notes | March 15, 2018 | 8.75% | March 15 & September 15 | $ 27,617 |
| 2019 senior notes | July 23, 2019 | 8.75% | January 23 & July 23 | 15,572 |
| 2022 senior notes[(1)] | January 23, 2022 | 8.75% | January 23 & July 23 | 17,384 |
| | | | | $ 60,573 |

(1) Annual interest rate for the first year is 9.75% and then 8.75% thereafter.

The senior notes are direct senior unsecured obligations of the Company, ranking pari passu with all other present and future unsecured and unsubordinated indebtedness of the Company. At any time prior to three years before the senior note maturity date, the Company can redeem up to 35 percent of the principal amount of the senior notes at a premium to face value. Within three years of maturity, the Company may redeem up to 100 percent of the senior notes at a premium to face value. Within one year of maturity, the Company may redeem up to 100 percent of the senior notes at the principal amount. On March 15, 2017, the Company issued a notice for early redemption of all outstanding 2018 senior notes (note 8).

The senior notes have a cross-default provision with the Company's credit facility (note 9a). In addition, the senior notes indenture contains restrictions on certain payments including dividends, retirement of subordinated debt and stock repurchases. The permitted amount of any restricted payment is limited to:

i) To the extent the Company's Consolidated Debt (defined as the sum of the Company's period end balance of bank indebtedness, TOU share margin loans and gas over bitumen royalty financing) Ratio is less than 3.0 to 1.0, the sum of 50 percent of income before interest, taxes, depletion and depreciation and non-cash items from January 1, 2011 to the end of the most recently completed fiscal quarter plus 100 percent of the fair market value of any equity contributions made to the Company during that period less the sum of all restricted payments during that period; and

ii) To the extent the Company's Consolidated Debt Ratio is greater than or equal to 3.0 to 1.0 pro forma for the proposed restricted payment, $50 million plus 100 percent of the fair market value of any equity contributions made to the Company.

The Company was in compliance with all covenants at December 31, 2016.

At December 31, 2016 the senior notes are presented net of $0.5 million (December 31, 2015 - $3.3 million) in issue costs which are amortized using a weighted average effective interest rate of 9.2 percent.

## 12. GAS OVER BITUMEN ROYALTY FINANCING

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| Balance, beginning of year | **$ 10,011** | $ 15,390 |
| Payments | **(2,164)** | (3,704) |
| Change in fair value | **497** | (1,675) |
| Balance, end of year | **$ 8,344** | $ 10,011 |
| | | |
| Gas over bitumen royalty financing – current | **$ 3,390** | $ 2,604 |
| Gas over bitumen royalty financing – non-current | **4,954** | 7,407 |
| | **$ 8,344** | $ 10,011 |

In 2014, the Company entered into an agreement whereby the Company received cash proceeds of $21.3 million in exchange for an obligation to make a monthly cash payment equivalent to a portion of the Company's monthly gas over bitumen royalty adjustment entitlements until final expiries in June 2021. Monthly payments under the arrangement are due on the 25th day following the entitlement month.

At the inception of the arrangement, the estimated future payments were determined using the same formula as the Company's monthly gas over bitumen royalty adjustment entitlements under the Alberta Natural Gas Royalty Regulation based on a January 1, 2014 forecast for the Alberta gas reference price ("base cash payment"). In the event that the actual Alberta gas reference price for a month causes the actual monthly cash payment under the arrangement to differ from the base cash payment, the Company is required to (a) pay 65 percent of any increase from the base cash payment, or (b) deduct 100 percent of any decrease from the base cash payment. Security for the gas over bitumen royalty financing is provided by an interest in certain lands of the Company and by the Company's entitlement to future gas over bitumen royalty adjustments.

The gas over bitumen royalty financing is a hybrid financial instrument comprised of a debt host with an embedded derivative related to indexation of the future cash payments to changes in the future Alberta gas reference price. The Company has designated the gas over bitumen royalty financing as a financial liability which is measured at fair value through profit and loss. For the year ended December 31, 2016, an unrealized loss of $0.5 million (December 31, 2015 – unrealized gain of $1.7 million) is included in finance expense related to the change in fair value of the gas over bitumen royalty financing.

As at December 31, 2016, if future natural gas prices changed by $0.25 per GJ with all other variables held constant, the fair value of the gas over bitumen royalty financing and after tax net loss for the period would change by $0.9 million (December 31, 2015 - $1.2 million).

## 13. PROVISIONS

| | 2016 | 2015 |
|---|---|---|
| Decommissioning obligations, beginning of year | **$ 159,169** | $ 222,976 |
| Obligations incurred | **177** | 1,442 |
| Obligations disposed (note 5a) | **(129,602)** | (1,939) |
| Change in risk free rate | **10,184** | 617 |
| Change in estimates | **(5,148)** | (60,372) |
| Obligations settled | **(3,803)** | (7,589) |
| Accretion (note 18) | **2,643** | 4,034 |
| Decommissioning obligations, end of year | **33,620** | 159,169 |
| Restructuring costs (b) | **4,154** | – |
| Balance, end of year | **$ 37,774** | $ 159,169 |
| | | |
| Provisions – current | **7,656** | 1,981 |
| Provisions – non-current | **30,118** | 157,188 |
| | **$ 37,774** | $ 159,169 |

### a) Decommissioning obligations

Total future decommissioning obligations are estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future periods.

The Company adjusts the decommissioning obligations on each period end date for changes in the risk free interest rate. Accretion is calculated on the adjusted balance after taking into account additions and dispositions to property, plant, and equipment. Decommissioning obligations are also adjusted for revisions to future cost estimates and the estimated timing of costs to be incurred in future years.

During the years ended December 31, 2016 and 2015, the Company achieved efficiencies and cost savings by utilizing internal labor and equipment rather than third party services for various stages of reclamation and abandonment. This resulted in a revision to estimated future abandonment liabilities for all oil and natural gas assets.

The following significant assumptions were used to estimate the Company's decommissioning obligations:

| | **December 31, 2016** | December 31, 2015 |
|---|---|---|
| Undiscounted obligations | **$ 37,877** | $ 179,325 |
| Average risk free rate | **2.3%** | 2.3% |
| Inflation rate | **1.5%** | 1.5% |
| Expected timing of settling obligations | **1 to 25 years** | 1 to 25 years |

**b) Restructuring costs**

| | **Employee downsizing costs** | **Onerous office lease contract** | **Total** |
|---|---|---|---|
| Balance, beginning of year | $ – | $ – | $ – |
| Recognized in 2016 | 2,926 | 2,712 | 5,638 |
| Payments in 2016 | (1,320) | (164) | (1,484) |
| Balance, end of year | 1,606 | 2,548 | 4,154 |
| | | | |
| Restructuring costs – current | 1,606 | 2,038 | 3,644 |
| Restructuring costs – non-current | – | 510 | 510 |
| **Total** | **$ 1,606** | **$ 2,548** | **$ 4,154** |

As a result of the Company's disposition of the Shallow Gas Properties on October 1, 2016 (note 5), the Company's employee base and office space requirements were significantly reduced. Restructuring costs of $5.6 million were expensed, comprised of employee downsizing costs of $2.9 million and office lease obligations associated with surplus office space of $2.7 million. Payments made in 2016 with respect to restructuring costs were $1.5 million.

The unused corporate office space is recorded as an onerous contract as the unavoidable costs associated with the lease contract exceed the expected economic benefits to be received.

## 14. COMMITMENTS

At December 31, 2016, the Company's contractual obligations over the next five years and thereafter are as follows:

| **Contractual repayments of financial liabilities *($ thousands)*** | **2017** | **2018** | **2019** | **2020** | **2021 and Thereafter** | **Total** |
|---|---|---|---|---|---|---|
| Accounts payable and accrued liabilities | 21,257 | – | – | – | – | **21,257** |
| Fair value of derivatives | 9,221 | 2,023 | – | – | – | **11,244** |
| TOU share margin loans | 39,953 | – | – | – | – | **39,953** |
| Senior notes – principal [(1)] | – | 27,617 | 15,572 | – | 17,384 | **60,573** |
| Gas over bitumen royalty financing | 3,390 | 2,416 | 1,600 | 615 | 323 | **8,344** |
| Drilling commitments | 3,000 | – | – | – | – | **3,000** |
| Pipeline transportation commitments | 7,099 | 9,454 | 8,525 | 4,824 | 2,336 | **32,238** |
| Office and other operating lease commitments | 4,049 | 1,022 | 14 | – | – | **5,085** |
| Total | 87,969 | 42,532 | 25,711 | 5,439 | 20,043 | **181,694** |

(1) Senior Note contractual obligations reflect the exchange of $8.4 million 2018 Senior Notes and $9.0 million 2019 Senior Notes for $17.4 million 2022 Senior Notes completed on January 23, 2017 (note 11).

## 15. SHARE CAPITAL

| | **December 31, 2016** | | December 31, 2015 | |
|---|---|---|---|---|
| | **Shares *(thousands)*** | **Amount *($thousands)*** | Shares *(thousands)* | Amount *($thousands)* |
| Balance, beginning of year | **19,115** | **$ 1,297,911** | 7,504 | $ 1,258,840 |
| Flow-through shares | **491** | **839** | – | – |
| Issued pursuant to share purchase rights | **33,268** | **27,082** | – | – |
| Issued pursuant to share based payment plans | **807** | **1,184** | 165 | 1,019 |
| Redemption of convertible debentures | **–** | **–** | 11,446 | 38,052 |
| Balance, end of year | **53,681** | **$ 1,327,016** | 19,115 | $ 1,297,911 |

**a) Authorized**

Authorized capital consists of an unlimited number of common shares. On March 24, 2016, shareholders of the Company approved the consolidation of common shares on the basis of 20 common shares to one common share, which has been retroactively applied throughout these consolidated financial statements.

**b) Flow through shares**

On November 17, 2016, the Company issued 0.5 million flow-through shares at a price of $2.15 per share for total gross cash proceeds of $1.1 million. The implied premium received in excess of the fair value of the common shares on the date of issue was $0.2 million or $0.44 per share and has been recorded in accounts payable and accrued liabilities pending the incurrence of qualified exploration and development expenditures by the Company. As at December 31, 2016 the Company was committed to spend $1.1 million on qualified exploration expenditures by December 31, 2017. The expenditures have been incurred in 2017 and renounced to investors with an effective renunciation date of December 31, 2016.

**c) Share purchase rights**

On December 7, 2015, the Company filed a short form prospectus with the security regulatory authorities in connection with a rights offering to issue common shares of the Company for gross proceeds of $25 million. The rights offering was fully backstopped by an entity controlled by the Chairmen of the Company's Board of Directors.

Pursuant to the rights offering, each registered holder of common shares as of December 16, 2015 received one right (a "Share Purchase Right") for each common share held. Each Share Purchase Right entitled the holder to acquire 0.2169 common shares upon payment of the exercise price of $3.26 per Share Purchase Right. The number of common shares received for each Share Purchase Right was calculated following the close of trading of the common shares on the Toronto Stock Exchange on December 22, 2015 based upon the volume weighted average price of the common shares for the preceding 20 consecutive trading days, being November 25, 2015 through to and including December 22, 2015.

For the year ended December 31, 2015, the Company recorded a gain of $7.5 million included in non-cash finance expense (note 18) related to the change in the carrying amount of the Share Purchase Rights derivative between filing of the prospectus on December 7, 2015 and determination of the number of common shares to be issued for each Share Purchase Right on December 22, 2015.

Upon closing of the rights offering on January 18, 2016, the Company issued an aggregate of 33.3 million common shares of the Company including 21.4 million issued to entities controlled by the Chairman of the Company's Board of Directors for proceeds of $16.1 million.

**d) Redemption of convertible debentures**

On December 31, 2015, the Company redeemed all of the outstanding 7.00% Convertible Debentures. The Company elected to satisfy the total principal amount of $34.9 million through the issuance of 11.4 million common shares in accordance with the indenture agreement.

**e) Per share information**

| | Year ended December 31, | |
|---|---|---|
| | **2016** | 2015 |
| *(thousands, except per share amounts)* | | |
| Net income (loss) – basic | **$ 107,149** | $ (89,274) |
| Effect of dilutive securities | **–** | – |
| Net income (loss) – diluted | **$ 107,149** | $ (89,274) |
| | | |
| Weighted average shares | | |
| Issued common shares | **50,985** | 7,598 |
| Effect of shares held in trust (note 17) | **(252)** | (91) |
| Weighted average common shares outstanding – basic | **50,733** | 7,507 |
| Effect of dilutive securities | **3,305** | – |
| Weighted average common shares outstanding – diluted | **54,038** | 7,507 |
| | | |
| Income (loss) per share - basic | **$ 2.11** | $ (11.89) |
| Income (loss) per share - diluted | **$ 1.98** | $ (11.89) |

In computing per share amounts for the year ended December 31, 2016, 1.5 million potentially issuable common shares through the share based compensation plans (2015 – 0.1 million) were excluded because they were anti-dilutive.

**f) Warrants and equity private placement**

On March 14, 2017, 5.1 million common shares and 6.5 million common share warrants were issued in connection with the issuance of the Second Lien Facility and private placement of common shares (note 8). Each warrant entitles the holder to acquire common shares on a one for one basis at an exercise price of $2.34 per share prior to March 14, 2020.

## 16. SHARE BASED PAYMENTS

Concurrent with the share consolidation, the Company's Board of Directors approved modifications to existing share based compensation agreements with directors, officers and employees of the Company. For the year ended December 31, 2016, incremental share based compensation expense associated with the modifications totalled $2.0 million.

### a) Share Option Plan

The Share Option Plan provides a long-term incentive to employees and directors to reward them on the basis of the Company's long-term performance. The Board of Directors administers the Share Option Plan and determines participants, number of Share Options and terms of vesting. The exercise price of the Share Options granted shall not be less than the value of the weighted average trading price for the Company's common shares for the five trading days immediately preceding the date of grant. Share Options granted have a maximum term of 5 years and vest evenly on each of the first, second, third and fourth grant anniversary dates.

Participants in the Share Option Plan may offer to surrender their options to the Company in exchange for a cash payment not to exceed the in-the-money value of the Share Options. The Company has the right to accept or refuse such offers. For the year ended December 31, 2016, the Company recorded $0.9 million in share based payments expense related to Share Options (2015 – $1.2 million), with no cash payments made in 2016 (2015 – nil).

The following tables summarize information about Share Options outstanding:

| | **December 31, 2016** | | December 31, 2015 | |
|---|---|---|---|---|
| | **Average Exercise Price (*$/share*)** | **Share Options (*thousands*)** | Average Exercise Price (*$/share*) | Share Options (*thousands*) |
| Balance, beginning of year | **1.23** | **14,794** | 1.33 | 12,819 |
| Modification | **1.11** | **(13,933)** | – | – |
| Granted | **1.42** | **2,275** | 0.69 | 2,150 |
| Exercised | **–** | **–** | 0.62 | (65) |
| Cancelled/forfeited | **1.69** | **(682)** | 1.23 | (50) |
| Expired | **3.41** | **(386)** | 3.59 | (60) |
| Balance, end of year | **1.71** | **2,068** | 1.23 | 14,794 |

| | **Options Outstanding** | | | **Options Exercisable** | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Number of Share Options (*thousands*)** | **Average Contractual Life (*years*)** | **Weighted Average Exercise Price (*$/share*)** | **Number of Share Options (*thousands*)** | **Weighted Average Exercise Price (*$/share*)** |
| $1.42 to $1.71 | 1,805 | 4.42 | $ 1.42 | – | $ – |
| $1.72 to $2.61 | 83 | 3.63 | 2.00 | 21 | 2.00 |
| $2.62 to $3.37 | 93 | 0.64 | 3.22 | 93 | 3.22 |
| $3.38 to $4.74 | 3 | 0.39 | 3.51 | 3 | 3.51 |
| $4.75 to $5.97 | 84 | 1.63 | 5.97 | 56 | 5.97 |
| **Total** | **2,068** | **4.10** | **$ 1.71** | **173** | **$ 3.98** |

The Company used the Black Scholes pricing model to calculate the estimated fair value of the outstanding Share Options. The following assumptions were used to arrive at the estimate of fair value as at the date of grant:

| | **2016** | 2015 |
|---|---|---|
| Dividend yield (%) | **0.0** | 0.0 |
| Forfeiture rate (%) | **20.6** | 20.6 |
| Expected volatility (%) | **60.7** | 49.8 |
| Risk-free interest rate (%) | **0.5** | 0.4 |
| Expected life (years) | **3.2** | 3.2 |
| Vesting period (years) | **4.0** | 4.0 |
| Contractual life (years) | **5.0** | 5.0 |
| Weighted average grant date fair value | **$ 0.73** | $ 0.18 |

### b) Restricted Rights Plan

The Company has a Restricted Rights Plan for certain officers, employees and consultants. Restricted Rights granted under the Restricted Rights Plan may be exercised during a period (the "Exercise Period") not exceeding five years from the date upon which the Restricted Rights were granted. The Restricted Rights typically vest on a graded basis over two years. At the expiration of the Exercise Period, any Restricted Rights which have not been exercised shall expire. Upon vesting, the plan participant is entitled to receive one common share for each right held at no cost.

For the year ended December 31, 2016, share based payments expense in respect of Restricted Rights outstanding was $0.9 million (2015 – nil).

The following table shows changes in the Restricted Rights outstanding under the Restricted Rights Plan:

| | **2016** | 2015 |
|---|---|---|
| *(thousands)* | | |
| Balance, beginning of year | **40** | 618 |
| Modification | **(38)** | – |
| Granted | **1,082** | 2,727 |
| Exercised | **(811)** | (3,280) |
| Forfeited | **–** | (25) |
| Balance, end of year | **273** | 40 |

### c) Performance Share Rights Plan

The Company has a Performance Share Rights Plan for the Company's senior management team. Performance Rights granted under the Performance Share Rights Plan vest two years after the date upon which the Performance Rights were granted. The Performance Rights that vest and become redeemable are a multiple of the Performance Rights granted dependent upon the achievement of certain performance metrics over the vesting period. Vested Performance Rights can be settled in cash or Restricted Rights, at the discretion of the Board of Directors. Should participants of the Performance Share Rights Plan leave the organization other than through retirement or termination without cause prior to the vesting date, the Performance Rights would be forfeited.

At December 31, 2016, the Company had 1.0 million Performance Share Rights issued and outstanding under the Performance Share Rights Plan (December 31, 2015 – 2.3 million).

For the year ended December 31, 2016, share based payments expense in respect of the Performance Share Rights outstanding was $0.5 million (2015 – nil) as a result of performance multiplier adjustments related to performance share units issued and outstanding.

### d) Compensation awards

The Company has agreements in place with certain employees whereby over a period of three years they may be entitled to receive shares of the Company purchased on the open market by an independent trustee if they remain employees of the Company during such time. This does not dilute equity or involve the issuance of shares from treasury. The shares purchased by the Trustee are reported as shares held in trust (note 17).

At December 31, 2016, the Company had 1.1 million of these awards issued and outstanding (2015 – 4.0 million).

For the year ended December 31, 2016, $0.4 million in share based payments expense was recorded in respect of the awards (2015 – $0.6 million).

The Company also has agreements in place with directors and certain employees whereby, in the case of directors, upon retirement from the board of directors, or in the case of employees, over a period of two years if they remain employees of the Company during such time, may be entitled to receive at the discretion of the Board, cash, a grant of Restricted Rights or shares of the Company purchased on the open market by an independent trustee.

At December 31, 2016, the Company had 2.2 million of these awards issued and outstanding (2015 – 3.5 million).

For the year ended December 31, 2016, $3.2 million in share based payments expense was recorded in respect of the compensation awards granted (2015 – $2.1 million).

## 17. SHARES HELD IN TRUST

| | **December 31, 2016** | | December 31, 2015 | |
|---|---|---|---|---|
| | **Shares *(thousands)*** | **Amount *($thousands)*** | Shares *(thousands)* | Amount *($thousands)* |
| Balance, beginning of year | **47** | **$ 1,177** | 49 | $ 1,387 |
| Shares purchased and held in trust | **218** | **162** | 51 | 1,109 |
| Share based payment settlements | **(5)** | **(28)** | (53) | (1,319) |
| Balance, end of year | **260** | **$ 1,311** | 47 | $ 1,177 |

The Company has compensation agreements in place with employees whereby they may be entitled to receive shares of the Company purchased on the open market by a trustee. The balance of shares held in trust represents the cumulative cost of shares held by the trustee for the benefit of employees that have not yet been issued to employees.

## 18. FINANCE EXPENSE

The components of finance expense are as follows:

| | Year ended December 31, 2016 | 2015 |
|---|---|---|
| Cash interest | | |
| Interest on senior notes | **11,942** | 24,062 |
| Interest on convertible debentures | **–** | 2,441 |
| Interest on bank indebtedness | **2,749** | 4,143 |
| Total cash interest | **14,691** | 30,646 |
| Non-cash finance expense | | |
| Amortization of debt issue costs | **509** | 2,036 |
| Accretion on decommissioning obligations (note 13) | **2,643** | 4,034 |
| Accretion on gas over bitumen provision | **–** | 498 |
| Change in fair value of gas over bitumen royalty financing (note 12) | **497** | (1,675) |
| Change in fair value of TOU share margin loans (note 10) | **6,507** | (171) |
| Change in carrying amount of share purchase rights derivative (note 15) | **–** | (7,478) |
| Total non-cash finance expense | **10,156** | (2,756) |
| **Finance expenses recognized in net income (loss)** | **24,847** | 27,890 |

## 19. CHANGES IN NON-CASH WORKING CAPITAL INFORMATION

| | Year ended December 31, 2016 | 2015 |
|---|---|---|
| Accounts receivable | **$ 8,059** | $ 30,765 |
| Prepaid expenses and deposits | **2,151** | (1,506) |
| Accounts payable and accrued liabilities | **(17,364)** | (53,227) |
| Change in non-cash working capital | **$ (7,154)** | $ (23,968) |

The change in non-cash working capital has been allocated to the following activities:

| | Year ended December 31, 2016 | 2015 |
|---|---|---|
| Operating | **$ (4,910)** | $ 15,813 |
| Financing | **216** | – |
| Investing | **(2,460)** | (39,781) |
| Change in non-cash working capital | **$ (7,154)** | $ (23,968) |

## 20. FINANCIAL RISK MANAGEMENT

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board of Directors has implemented and monitors compliance with risk management policies.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

### a) Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners, oil and natural gas marketers and derivative contract counterparties.

Credit risk associated with cash and cash equivalents and restricted cash balances is managed by maintaining balances with financial institutions that have investment grade credit ratings.

Receivables from oil and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large, well established purchasers. The Company historically has not experienced any significant collection issues with its oil and natural gas marketing receivables. Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure. However, the receivables are generally from participants in the oil and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs, the risk of unsuccessful drilling and oil and gas production; in addition, further risk exists with joint venture partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from oil and natural gas marketers or joint venture partners, however, the Company does have the ability in some cases to withhold production or amounts payable to joint venture partners in the event of non-payment.

The Company manages the credit exposure related to derivatives by engaging in risk management transactions with credit worthy counterparties, and periodically monitoring counterparty credit assessments.

The carrying amount of cash and cash equivalents, restricted cash, accounts receivable and fair value of derivative assets represents the Company's maximum credit exposure. As at December 31, 2016, the Company's cash and cash equivalents balance was $2.9 million (December 31, 2015 - $2.1 million), restricted cash was $2.0 million (December 31, 2015 – nil), accounts receivable was $11.5 million (December 31, 2015 - $19.5 million), and derivative assets was $10.7 million (December 31, 2015 - $3.7 million). The Company's credit provisions are represented by its allowance for doubtful accounts receivable as at December 31, 2016 of $0.8 million (December 31, 2015 – $0.6 million). The amount of the allowance was determined by assessing the probability of collection for each past due receivable. The Company is currently involved in negotiations with the joint venture partners involved to recover the full amount of the receivables in question. The total amount of accounts receivables 90 days past due amounted to $2.0 million as at December 31, 2016 (December 31, 2015 – $0.9 million).

**b) Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking harm to the Company's reputation.

The Company anticipates that cash flows including cash flow from operating activities, proceeds from potential future asset dispositions and future disposition of its TOU share investment, cash and cash equivalents, and access to credit facilities will provide the required funds to discharge the Company's obligations, carry out exploration and development programs and fund ongoing operations for the foreseeable future.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

The Company's minimum contractual obligations, excluding estimated interest payments, at December 31, 2016 are detailed in note 14.

**c) Market risk**

Market risk is the risk that changes in market prices such as foreign exchange rates, TOU share price, commodity prices and interest rates will affect the Company's net income or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

The Company utilizes both financial derivatives and fixed-price physical delivery sales contracts to manage market risks related to commodity prices, foreign currency rates and TOU share investment prices. All such transactions are conducted in accordance with the Company's Risk Management Policy, which has been approved by the Board of Directors.

**i) Commodity price risk**

Commodity price risk is the risk that the fair value or future cash flow will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted not only by the relationship between the Canadian and United Stated dollar, but also by world economic events that dictate the levels of supply and demand. The Company manages commodity price risk through the use of various financial derivatives and fixed-price physical delivery sales contracts.

As at December 31, 2016, the Company has variable priced physical natural gas sales contracts based on future market prices. These contracts are not classified as non-financial derivatives due to the fact that the settlement price corresponds directly with fluctuations in natural gas prices.

***Natural gas contracts***

At December 31, 2016 the Company entered into the following physical fixed natural gas sales arrangements at AECO:

| Term | Sold/bought | Volumes (*GJ/d*) | Average price (*$CAD/GJ*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 | Sold | 56,100 | 3.28 | (75) |
| January 2017 – December 2017 | Sold | 12,500 | 3.11 | 697 |
| February 2017 | Sold | 40,000 | 3.39 | 504 |
| February 2017 – December 2017 | Sold | 2,500 | 3.20 | 234 |
| March 2017 | Sold | 10,000 | 3.32 | 125 |
| April 2017 – December 2017 | Sold | 5,000 | 3.20 | 391 |

At December 31, 2016 the Company had entered into the following financial fixed natural gas sales arrangements at AECO:

| Term | Sold/bought | Volumes (*GJ/d*) | Average price (*$CAD/GJ*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 – December 2017 | Sold | 7,500 | 3.16 | (265) |
| March 2017 | Sold | 5,000 | 3.29 | (9) |

At December 31, 2016 the Company had entered into the following financial basis differential contracts between AECO and NYMEX trading:

| Term | Sold/bought | Volumes (*MMBTU/d*) | differential price (*$USD/MMBTU*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 – December 2017 | Sold | 30,000 | (0.69) | 5,526 |
| January 2017 – December 2017 | Bought | (30,000) | (0.93) | (2,058) |
| January 2018 – December 2018 | Sold | 25,000 | (0.71) | 2,217 |
| January 2018 – December 2018 | Bought | (25,000) | (0.82) | (805) |

In January 2017, the Company crystalized these basis differential contracts resulting in net cash proceeds of $4.9 million.

***Oil contracts***

At December 31, 2016, the Company had entered into the following costless collar oil sales arrangements which settle in $USD.

| Term | Volumes at WTI (*bbls/d*) | Floor price (*$USD/bbl*) | Ceiling price (*$USD/bbl*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 – December 2017(1) | 250 | 44.50 | 49.55 | (933) |
| January 2017 – December 2017 | 500 | 50.00 | 59.40 | (205) |

(1) In January 2017, the Company crystalized this contract at a cost of $0.9 million and reset the floor price to $USD50.00 and the ceiling price to $USD61.50

The following table is a summary of the fair value of the Company's financial contracts by type:

| | Year ended December 31, **2016** | 2015 |
|---|---|---|
| Physical natural gas contracts | **1,876** | (131) |
| Financial natural gas contracts | **4,606** | (1,824) |
| Financial oil contracts | **(1,138)** | 2,006 |
| Financial foreign exchange contracts | **(5,022)** | (13,069) |
| Fixed portion of retained shallow gas marketing arrangements (1) | **(4,698)** | – |
| Non-fixed portion of retained shallow gas marketing arrangements | **3,809** | – |
| **Fair value of derivatives** | **(567)** | (13,018) |
| | | |
| Derivative assets – current | **8,326** | 2,319 |
| Derivative assets – non-current | **2,351** | 1,411 |
| Derivative liabilities - current | **(9,221)** | (9,353) |
| Derivative liabilities – non-current | **(2,023)** | (7,395) |
| **Fair value of derivatives** | **(567)** | (13,018) |

(1) Upon entering into these arrangements, the term of the put option between the periods of November 1, 2016 and March 31, 2018 was fixed at a cost of $5.1 million which settles monthly over the term. This portion of the contract is recorded at amortized cost. During the year ended December 31, 2016, payments of $0.4 million were recorded as a reduction to this liability.

The following table details the Company's changes in fair value of commodity price derivatives:

| | Year ended December 31, **2016** | 2015 |
|---|---|---|
| Unrealized gain (loss) on financial oil contracts | **(3,144)** | (4,409) |
| Unrealized gain (loss) on financial natural gas contracts | **6,430** | (3,165) |
| Unrealized gain (loss) on physical natural gas contracts | **2,007** | (80) |
| Unrealized gain (loss) on forward foreign exchange contracts | **8,047** | (8,409) |
| **Unrealized change in fair value of commodity price derivatives** | **13,340** | (16,063) |
| Realized gain (loss) on financial oil contracts | **1,036** | 6,651 |
| Realized gain (loss) on financial natural gas contracts | **6,224** | 5,161 |
| Realized loss on forward foreign exchange contracts | **(2,559)** | (7,186) |
| **Change in fair value of commodity price derivatives** | **18,041** | (11,437) |

***Natural gas contracts - sensitivity analysis***

As at December 31, 2016, if future natural gas prices changed by $0.25 per GJ with all other variables held constant, the fair value of commodity price derivatives and after tax net income for the period would change by $0.6 million. Fair value sensitivity was based on published forward AECO and NYMEX prices.

***Oil contracts - sensitivity analysis***

As at December 31, 2016, if future oil prices increased by $5.00 per boe with all other variables held constant, the fair value of commodity price derivatives and after tax net income for the period would decrease by $1.0 million. If future oil prices decreased by $5.00 per boe with all other variables held constant, the fair value of commodity price derivatives and after tax net income for the period would increase by $0.6 million. Fair value sensitivity was based on published forward WTI and WCS prices.

### ii) Foreign currency exchange rate risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows of the Company will fluctuate as a result of changes in foreign exchange rates. The majority of the Company's oil and natural gas sales are denominated in Canadian dollars. As the demand for oil and natural gas is substantially driven by the demand in the United States, the Company's exposure to US dollar foreign exchange risk is indirectly driven by the price of oil and natural gas. From time to time, the Company also uses foreign exchange contracts to mitigate the effects of fluctuations in exchange rates on the Company's cash flows.

***Foreign exchange contracts***

At December 31, 2016, the Company had entered into the following U.S. dollar forward sales arrangement:

| Term | Notional (*$USD/month*) | Strike rate (*$CAD/$USD*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|
| January 2017 – March 2018[1] | 3,500,000 | 1.25 | (5,134) |

(1) If the average monthly exchange rate is greater than the strike rate, the Company pays $USD 3,500,000 multiplied by the difference between the average monthly exchange rate and the strike rate.

In January 2017, the Company terminated the forward U.S. dollar sales arrangement at a cost of $4.3 million.

At December 31, 2016, the Company had entered into the following U.S. dollar boosted forward sales arrangement:

| Term | Notional (*$USD/month*) | Boosted notional[1] (*$USD/month*) | Strike rate (*$CAD/$USD*) | Fair Value (*$CAD thousands*) |
|---|---|---|---|---|
| January 2017 – March 2018[2] | 1,000,000 | 3,000,000 | 1.25 | 112 |

(1) If the spot rate at expiry of each contract month is below the strike rate, the Company pays $USD 3,000,000 multiplied by the difference between the spot rate at expiry and the strike rate.

(2) If the spot rate at expiry of each contract month is above the strike rate, the Company receives $USD 1,000,000 multiplied by the difference between the spot rate at expiry and the strike rate. Cumulative receipts on this contract are limited to a total of $0.8 million, after which the contract terminates.

***Foreign exchange contracts - sensitivity analysis***

As at December 31, 2016, if future exchange rates increased by $0.10 $CAD/$USD with all other variables held constant, the fair value of foreign exchange derivatives and after tax net income for the period would decrease by $7.0 million. If future exchange rates decreased by $0.10 $CAD/$USD with all other variables held constant, the fair value of foreign exchange derivatives and after tax net income for the period would increase by $3.4 million. Fair value sensitivity was based on published forward $CAD/$USD rates.

### iii) Interest rate risk

The Company utilizes a credit facility which bears a floating rate of interest and as such is subject to interest rate risk. Increased future interest rates will decrease future cash flows and net income or loss, thereby potentially affecting the Company's bank indebtedness. The Company had no interest rate swap or financial contracts in place as at or during the year ended December 31, 2016 (December 31, 2015 – nil).

***Interest rate sensitivity analysis***

For the years ended December 31, 2016 and 2015, if interest rates changed by one percent with all other variables held constant, the impact on interest expense and net income (loss) would be nominal, as the Company's bank indebtedness was minimal.

## d) Fair value of financial assets and liabilities

The Company's fair value measurements are classified as one of the following levels of the fair value hierarchy:

Level 1 – inputs represent unadjusted quoted prices in active markets for identical assets and liabilities. An active market is characterized by a high volume of transactions that provides pricing information on an ongoing basis.

Level 2 – inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These valuations are based on inputs that can be observed or corroborated in the marketplace, such as market interest rates or forward prices for commodities.

Level 3 – inputs for the asset or liability are not based on observable market data.

The Company aims to maximize the use of observable inputs when preparing calculations of fair value. Classification of each measurement into the fair value hierarchy is based on the lowest level of input that is significant to the fair value calculation.
The fair value of cash and cash equivalents, restricted cash, accounts receivable, and accounts payable and accrued liabilities approximate their carrying amounts due to their short terms to maturity. Bank indebtedness bears interest at a floating market rate and accordingly the fair market value approximates the carrying amount.

The fair value of the gas over bitumen royalty financing is estimated by discounting future cash payments based on the forecasted Alberta gas reference price (note 12) multiplied by the contracted deemed volume. This fair value measurement is classified as level 3 as significant unobservable inputs, including the discount rate and forecasted Alberta gas reference prices, are used in determination of the carrying amount. The discount rate of 12.2% was determined on inception of the agreement based on the characteristics of the instrument. The forecasted Alberta gas reference prices for the remaining term are based on AECO forward market pricing with adjustments for historical differences between the Alberta reference price and market prices.

The fair value of the TOU share margin loans are estimated using significant unobservable inputs including discount rates and measures of future volatility required to fair value the embedded TOU share price put options. This fair value measurement is classified as level 3 as significant unobservable inputs, including discount rates and measures of future volatility are used in determination of the carrying amount (see note 10).

The fair value of financial assets and liabilities, excluding working capital, is attributable to the following fair value hierarchy levels:

| | | | | Fair value | | |
|---|---|---|---|---|---|---|
| **As at December 31, 2016** | **Gross** | **Netting[(1)]** | **Carrying Amount** | **Level 1** | **Level 2** | **Level 3** |
| **Financial assets** | | | | | | |
| Fair value through profit and loss | | | | | | |
| TOU share investment | **66,343** | **–** | **66,343** | **66,343** | **–** | **–** |
| Derivatives – current | **10,528** | **(2,202)** | **8,326** | **–** | **8,326** | **–** |
| Derivatives – non-current | **4,157** | **(1,806)** | **2,351** | **–** | **2,351** | **–** |
| **Financial liabilities** | | | | | | |
| Financial liabilities at amortized cost | | | | | | |
| Senior notes | **60,120** | **–** | **60,120** | **–** | **59,664** | **–** |
| Fair value through profit and loss | | | | | | |
| Derivatives – current | **11,423** | **(2,202)** | **9,221** | **–** | **9,221** | **–** |
| Derivatives – non-current | **3,829** | **(1,806)** | **2,023** | **–** | **2,023** | **–** |
| Gas over bitumen royalty financing – current | **3,390** | **–** | **3,390** | **–** | **–** | **3,390** |
| Gas over bitumen royalty financing – non-current | **4,954** | **–** | **4,954** | **–** | **–** | **4,954** |
| TOU share margin loans – current | **39,953** | **–** | **39,953** | **–** | **–** | **39,953** |

(1) Derivative assets and liabilities presented in the statement of financial position are shown net of offsetting assets or liabilities where the arrangement provides for the legal right and intention for net settlement exists.

| | | | | Fair value | | |
|---|---|---|---|---|---|---|
| As at December 31, 2015 | **Gross** | **Netting[(1)]** | **Carrying Amount** | **Level 1** | **Level 2** | **Level 3** |
| **Financial assets** | | | | | | |
| Fair value through profit and loss | | | | | | |
| TOU share investment | 145,275 | – | 145,275 | 145,275 | – | – |
| Derivatives – current | 2,667 | (348) | 2,319 | – | 2,319 | – |
| Derivatives – non-current | 1,411 | – | 1,411 | – | 1,411 | – |
| **Financial liabilities** | | | | | | |
| Financial liabilities at amortized cost | | | | | | |
| Senior notes | 271,658 | – | 271,658 | – | 168,000 | – |
| Fair value through profit and loss | | | | | | |
| Derivatives – current | 9,701 | (348) | 9,353 | – | 9,353 | – |
| Derivatives – non-current | 7,395 | – | 7,395 | – | 7,395 | – |
| Gas over bitumen royalty financing – current | 2,604 | – | 2,604 | – | – | 2,604 |
| Gas over bitumen royalty financing – non-current | 7,407 | – | 7,407 | – | – | 7,407 |
| TOU share margin loans - current | 60,059 | – | 60,059 | – | – | 60,059 |

(1) Derivative assets and liabilities presented in the statement of financial position are shown net of offsetting assets or liabilities where the arrangement provides for the legal right and intention for net settlement exists.

## 21. DEFERRED INCOME TAXES

The provision for income taxes in the financial statements differs from the result that would have been obtained by applying the combined federal and provincial tax rate to the Company's income (loss) before income tax. This difference results from the following items:

| | Years ended December 31, 2016 | 2015 |
|---|---|---|
| Net income (loss) before income tax | **$ 107,149** | $ (89,274) |
| Combined federal and provincial tax rate | **27.0%** | 26.0% |
| Computed income tax expense (recovery) | **$ 28,930** | $ (23,211) |
| Increase (decrease) in income taxes resulting from: | | |
| Non-deductible expenses | **1,596** | 981 |
| Non-taxable capital (gain) loss | **(18,095)** | 13,635 |
| Change in unrecognized tax asset | **(13,113)** | 16,653 |
| Change in tax rate | **–** | (8,745) |
| Other | **682** | 687 |
| Deferred income taxes | **$ –** | $ – |

The Alberta income tax rate increased to 12 percent from 10 percent on July 1, 2015, resulting in an effective tax rate of 27 percent for 2016 and 26 percent for 2015. There were no changes to federal statutory income tax rates.

The following table summarizes the deferred income tax liabilities of the Company and its subsidiaries, which are offset against certain deferred income tax assets:

| | Years ended December 31, 2016 | 2015 |
|---|---|---|
| Liability: | | |
| Property, plant and equipment | **$ –** | $ 34,609 |
| Marketable securities | **2,087** | – |
| Other | **3,264** | 3,205 |
| Total deferred income tax liabilities | **$ 5,351** | $ 37,814 |
| Asset: | | |
| Decommissioning obligation | **$ (5,351)** | $ (37,814) |

The unused tax losses and deductible temporary differences included in the Company's unrecognized deferred income tax assets are as follows:

| | Years ended December 31, 2016 | 2015 |
|---|---|---|
| Non-capital losses | **$ 138,012** | $ 163,404 |
| Capital losses | **139,937** | 161,625 |
| Property, plant and equipment | **50,163** | – |
| Decommissioning obligation | **2,061** | 30,985 |
| Gas over bitumen royalty financings | **8,344** | 10,011 |
| Marketable securities | – | 104,460 |
| Other | **18,886** | 4,752 |
| | **$ 357,403** | $ 475,237 |

At December 31, 2016, the unused non-capital losses expire between 2024 and 2036, and unused capital losses have no expiry date. The deductible temporary differences do not expire under current tax legislation. The petroleum and natural gas properties and facilities owned by the Company and its subsidiaries have an approximate tax basis of $317 million (December 31, 2015 – $276 million) available for future use as deductions from taxable income.

Deferred income tax assets have not been recognized in respect of these unused tax losses and temporary differences because it is not probable that future taxable profit will be available against which the Company can utilize the benefits.

## 22. KEY MANAGEMENT PERSONNEL

The Company has defined key management personnel as executive officers, as well as the Board of Directors, as they have the collective authority and responsibility for planning, directing and controlling the activities of the Company. The following table outlines the total compensation expense for key management personnel:

| | Years ended December 31, 2016 | 2015 |
|---|---|---|
| Short-term compensation | **$ 2,637** | $ 2,562 |
| Share based payments | **1,871** | 1,128 |
| | **$ 4,508** | $ 3,690 |

## 23. SUPPLEMENTAL DISCLOSURE

The Company's consolidated statements of income (loss) and comprehensive income (loss) are prepared primarily by nature of expense, with the exception of employee compensation costs which are included in both production and operating and general and administrative expenses.

The following table details the amount of total employee compensation costs included in production and operating and general and administrative expenses in the consolidated statements of income (loss) and comprehensive income (loss).

| | Year ended December 31, | |
|---|---|---|
| | **2016** | 2015 |
| Production and operating | **$ 4,986** | $ 8,319 |
| General and administrative | **18,336** | 20,343 |
| Restructuring costs | **2,926** | – |
| | **$ 26,248** | $ 28,662 |

During the year ended December 31, 2016, total employee compensation costs included share based payments of $5.9 million (2015 – $3.8 million) with the remainder being short-term fees and other short-term benefits.