

# MANAGEMENT'S REPORT

To the Shareholders of Birchcliff Energy Ltd.

The annual financial statements of Birchcliff Energy Ltd. for the year ended December 31, 2016 were prepared by management within the acceptable limits of materiality and are in accordance with International Financial Reporting Standards. Management is responsible for ensuring that the financial and operating information presented in the annual report is consistent with that shown in the financial statements.

The financial statements have been prepared by management in accordance with the accounting policies as described in the notes to the financial statements. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. When necessary, such estimates are based on informed judgments made by management.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of financial statements for reporting purposes.

KPMG LLP, an independent firm of Chartered Professional Accountants appointed by shareholders, have conducted an examination of the corporate and accounting records in order to express their opinion on the financial statements.

The Audit Committee, consisting of non-management directors, has met with representatives of KPMG LLP and management in order to determine if management has fulfilled its responsibilities in the preparation of the financial statements. The Board of Directors has approved the financial statements on the recommendation of the Audit Committee.

Respectfully,

(signed) *"Bruno P. Geremia"*

**Bruno P. Geremia,**

Vice-President and Chief Financial Officer

(signed) *"A. Jeffery Tonken"*

**A. Jeffery Tonken,**

President and Chief Executive Officer

Calgary, Canada

March 15, 2017

# INDEPENDENT AUDITORS' REPORT

To the Shareholders of Birchcliff Energy Ltd.

We have audited the accompanying financial statements of Birchcliff Energy Ltd., which comprise the statements of financial position as at December 31, 2016 and December 31, 2015, the statements of net loss and comprehensive loss, changes in shareholders' 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 FINANCIAL STATEMENTS

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the 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 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 financial statements present fairly, in all material respects, the financial position of Birchcliff Energy Ltd. as at December 31, 2016 and December 31, 2015, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

(signed) "KPMG LLP"

Chartered Professional Accountants

March 15, 2017  
Calgary, Canada

# BIRCHCLIFF ENERGY LTD.

## STATEMENTS OF FINANCIAL POSITION

(Expressed in thousands of Canadian dollars)

| <b>As at December 31,</b>                                   | <b>2016</b>      | <b>2015</b>      |
|---|------------------|------------------|
| <b>ASSETS</b>   |                  |                  |
| Current assets:   |                  |                  |
| Cash  | 47               | 57               |
| Accounts receivable (Note 16)                               | 62,572           | 23,410           |
| Prepaid expenses and deposits                               | 2,001            | 2,579            |
|   | <b>64,620</b>    | <b>26,046</b>    |
| Non-current assets:   |                  |                  |
| Exploration and evaluation (Note 5)                         | 53               | 247              |
| Petroleum and natural gas properties and equipment (Note 6) | 2,645,784        | 1,999,080        |
|   | <b>2,645,837</b> | <b>1,999,327</b> |
| <b>Total assets</b>   | <b>2,710,457</b> | <b>2,025,373</b> |
| <b>LIABILITIES</b>  |                  |                  |
| Current liabilities:  |                  |                  |
| Accounts payable and accrued liabilities                    | 92,115           | 47,584           |
| Fair value of financial instruments (Note 16)               | 9,433            | -                |
|   | <b>101,548</b>   | <b>47,584</b>    |
| Non-current liabilities:                                    |                  |                  |
| Revolving term credit facilities (Note 7)                   | 572,517          | 622,074          |
| Decommissioning obligations (Note 8)                        | 133,470          | 92,504           |
| Deferred income taxes (Note 9)                              | 99,599           | 116,171          |
| Capital securities (Note 10)                                | 48,916           | 48,606           |
|   | <b>854,502</b>   | <b>879,355</b>   |
| <b>Total liabilities</b>                                    | <b>956,050</b>   | <b>926,939</b>   |
| <b>SHAREHOLDERS' EQUITY</b>                                 |                  |                  |
| Share capital (Note 10)                                     |                  |                  |
| Common shares   | 1,464,567        | 783,481          |
| Preferred shares (perpetual)                                | 41,434           | 41,434           |
| Contributed surplus   | 63,847           | 60,625           |
| Retained earnings   | 184,559          | 212,894          |
|   | <b>1,754,407</b> | <b>1,098,434</b> |
| <b>Total shareholders' equity and liabilities</b>           | <b>2,710,457</b> | <b>2,025,373</b> |

Commitments (Note 17)

The accompanying notes are an integral part of these financial statements.

Approved by the Board

(signed) "Larry A. Shaw"  
**Larry A. Shaw**  
 Director

(signed) "A. Jeffery Tonken"  
**A. Jeffery Tonken**  
 Director

# BIRCHCLIFF ENERGY LTD.

## STATEMENTS OF NET LOSS AND COMPREHENSIVE LOSS

(Expressed in thousands of Canadian dollars, except per share information)

| Years Ended December 31,                             | 2016            | 2015            |
|--|-----------------|-----------------|
| <b>REVENUE</b>                                       |                 |                 |
| Petroleum and natural gas sales                      | 337,586         | 317,304         |
| Royalties  | (20,911)        | (11,548)        |
| Net revenue from oil and natural gas sales           | 316,675         | 305,756         |
| Realized gain on financial instruments (Note 16)     | 802             | -               |
| Unrealized (loss) on financial instruments (Note 16) | (9,433)         | -               |
|  | 308,044         | 305,756         |
| <b>EXPENSES</b>                                      |                 |                 |
| Operating (Note 11)                                  | 75,251          | 64,511          |
| Transportation and marketing                         | 42,989          | 34,804          |
| Administrative, net (Note 12)                        | 23,967          | 26,030          |
| Depletion and depreciation (Note 6)                  | 149,369         | 147,163         |
| Finance (Note 13)                                    | 33,940          | 26,015          |
| Dividends on capital securities (Note 10)            | 3,500           | 3,500           |
| (Gain) loss on sale of assets (Note 6)               | 9,489           | (7,339)         |
|  | 338,505         | 294,684         |
| Net income (loss) before taxes                       | (30,461)        | 11,072          |
| Income tax recovery (expense) (Note 9)               | 6,126           | (23,232)        |
| <b>NET LOSS AND COMPREHENSIVE LOSS</b>               | <b>(24,335)</b> | <b>(12,160)</b> |
| Net loss per common share (Note 10)                  |                 |                 |
| Basic  | (\$0.14)        | (\$0.11)        |
| Diluted  | (\$0.14)        | (\$0.11)        |

The accompanying notes are an integral part of these financial statements.

# BIRCHCLIFF ENERGY LTD.

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Expressed in thousands of Canadian dollars)

|   | Share Capital    |                  |                     |                   | Total            |
|---|------------------|------------------|---------------------|-------------------|------------------|
|   | Common Shares    | Preferred Shares | Contributed Surplus | Retained Earnings |                  |
| As at December 31, 2014                           | 782,671          | 41,434           | 53,118              | 229,054           | 1,106,277        |
| Dividends on perpetual preferred shares           | -                | -                | -                   | (4,000)           | (4,000)          |
| Exercise of stock options                         | 810              | -                | (225)               | -                 | 585              |
| Stock-based compensation                          | -                | -                | 7,732               | -                 | 7,732            |
| Net loss and comprehensive loss                   | -                | -                | -                   | (12,160)          | (12,160)         |
| As at December 31, 2015                           | 783,481          | 41,434           | 60,625              | 212,894           | 1,098,434        |
| Issue of common shares (Note 10)                  | 690,801          | -                | -                   | -                 | 690,801          |
| Share issue costs, net of tax (Note 10)           | (20,143)         | -                | -                   | -                 | (20,143)         |
| Dividends on perpetual preferred shares (Note 10) | -                | -                | -                   | (4,000)           | (4,000)          |
| Exercise of stock options (Note 10)               | 10,428           | -                | (2,831)             | -                 | 7,597            |
| Stock-based compensation (Note 12)                | -                | -                | 6,053               | -                 | 6,053            |
| Net loss and comprehensive loss                   | -                | -                | -                   | (24,335)          | (24,335)         |
| <b>As at December 31, 2016</b>                    | <b>1,464,567</b> | <b>41,434</b>    | <b>63,847</b>       | <b>184,559</b>    | <b>1,754,407</b> |

The accompanying notes are an integral part of these financial statements.

# BIRCHCLIFF ENERGY LTD.

## STATEMENTS OF CASH FLOWS

(Expressed in thousands of Canadian dollars)

| Years ended December 31,                                     | 2016      | 2015      |
|--|-----------|-----------|
| Cash provided by (used in):                                  |           |           |
| <b>OPERATING</b>   |           |           |
| Net loss and comprehensive loss                              | (24,335)  | (12,160)  |
| Adjustments for items not affecting operating cash:          |           |           |
| Unrealized loss on financial instruments                     | 9,433     | -         |
| Depletion and depreciation                                   | 149,369   | 147,163   |
| Stock-based compensation                                     | 2,478     | 3,206     |
| Finance  | 33,940    | 26,015    |
| (Gain) loss on sale of assets                                | 9,489     | (7,339)   |
| Income taxes expense (recovery)                              | (6,126)   | 23,232    |
| Interest paid (Note 13)                                      | (30,305)  | (22,861)  |
| Dividends on capital securities                              | 3,500     | 3,500     |
| Decommissioning expenditures                                 | (1,343)   | (893)     |
| Changes in non-cash working capital (Note 18)                | (5,586)   | (11,066)  |
|  | 140,514   | 148,797   |
| <b>FINANCING</b>   |           |           |
| Exercise of stock options                                    | 7,597     | 585       |
| Issue of common shares                                       | 690,801   | -         |
| Share issue costs  | (27,589)  | -         |
| Financing fees paid on credit facilities                     | (795)     | (940)     |
| Dividends on perpetual preferred shares                      | (4,000)   | (4,000)   |
| Dividends on capital securities                              | (3,500)   | (3,500)   |
| Net change in non-revolving term credit facilities           | -         | (129,970) |
| Net change in revolving term credit facilities               | (49,540)  | 283,340   |
|  | 612,974   | 145,515   |
| <b>INVESTING</b>   |           |           |
| Petroleum and natural gas properties and equipment           | (168,431) | (258,041) |
| Exploration and evaluation assets                            | (46)      | (113)     |
| Acquisition of petroleum and natural gas properties (Note 6) | (614,273) | -         |
| Sale of petroleum and natural gas properties and equipment   | 20,720    | 10,887    |
| Sale of exploration and evaluation assets                    | -         | 60        |
| Changes in non-cash working capital (Note 18)                | 8,532     | (47,102)  |
|  | (753,498) | (294,309) |
| Net change in cash   | (10)      | 3         |
| Cash, beginning of year                                      | 57        | 54        |
| <b>CASH, END OF YEAR</b>                                     | <b>47</b> | <b>57</b> |

The accompanying notes are an integral part of these financial statements.

# BIRCHCLIFF ENERGY LTD.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

*(Expressed In thousands Of Canadian Dollars, Unless Otherwise Stated)*

### 1. NATURE OF OPERATIONS

Birchcliff Energy Ltd. (“**Birchcliff**” or the “**Corporation**”) is domiciled and incorporated in Alberta, Canada. Birchcliff is engaged in the exploration for and the development, production and acquisition of petroleum and natural gas reserves in Western Canada. The Corporation’s financial year end is December 31. The address of the Corporation’s registered office is Suite 1000, 600 – 3<sup>rd</sup> Avenue S.W., Calgary, Alberta, Canada T2P 0G5. Birchcliff’s common shares, Series A Preferred Shares and Series C Preferred Shares are listed for trading on the Toronto Stock Exchange under the symbols “**BIR**”, “**BIR.PR.A**” and “**BIR.PR.C**”, respectively.

These financial statements were approved and authorized for issuance by the Board of Directors on March 15, 2017.

### 2. BASIS OF PREPARATION

These financial statements present Birchcliff’s financial results of operations and financial position under International Financial Reporting Standards (“**IFRS**”) as issued by IASB as at and for the years ended December 31, 2016 and December 31, 2015. The financial statements have been prepared in accordance with IFRS accounting policies and methods of computation as set forth in Note 3.

Operating, transportation and marketing expenses in profit or loss are presented as a combination of function and nature in conformity with industry practices. Depletion and depreciation, finance expenses, dividends on capital securities and gain or loss on sale of assets are presented in a separate line by their nature, while net administrative expenses are presented on a functional basis. Significant expenses such as salaries and benefits and stock-based compensation are presented by their nature in the notes to the financial statements.

Birchcliff’s financial statements are prepared on a historical cost basis, except for certain financial and non-financial assets and liabilities which have been measured at fair value. The Corporation’s financial statements include the accounts of Birchcliff only and are expressed in Canadian dollars, unless otherwise stated. Birchcliff does not have any subsidiaries.

### 3. SIGNIFICANT ACCOUNTING POLICIES

#### (a) Revenue Recognition

Revenue from the sale of petroleum and natural gas is recognized when volumes are delivered and title passes to an external party at contractual delivery points and are recorded gross of transportation charges incurred by the Corporation. The costs associated with the delivery, including transportation and production-based royalty expenses, are recognized in the same period in which the related revenue is earned and recorded.

#### (b) Cash and Cash Equivalents

Cash may consist of cash on hand, deposits and term investments held with a financial institution, with an original maturity of three months or less. Restricted cash is not considered part of cash and cash equivalents.

**(c) Jointly Owned Assets**

Certain activities of the Corporation are conducted jointly with others where the participants have a direct ownership interest in the related assets. Accordingly, the accounts of Birchcliff reflect only its working interest share of revenues, expenses and capital expenditures related to these jointly owned assets. The relationship with jointly owned asset partners have been referred to as joint venture in the remainder of the financial statements as this is common terminology in the Canadian oil and natural gas industry.

**(d) Exploration and Evaluation Assets**

Costs incurred prior to obtaining the right to explore a mineral resource are recognized as an expense in the period incurred.

Intangible exploration and evaluation expenditures are initially capitalized and may include mineral license acquisitions, geological and geophysical evaluations, technical studies, exploration drilling and testing and other directly attributable administrative costs. Tangible assets acquired which are consumed in developing an intangible exploration asset are recorded as part of the cost of the exploration asset. These costs are accumulated in cost centres by exploration area pending the determination of technical feasibility and commercial viability.

The technical feasibility and commercial viability of extracting a mineral resource in an exploration area is considered to be determinable when economic quantities of proved reserves are determined to exist. A review of each exploration project by area is carried out at each reporting date to ascertain whether such reserves have been discovered. Upon determination of commercial proved reserves, associated exploration costs are transferred from exploration and evaluation to developing and producing petroleum and natural gas properties and equipment as reported on the statements of financial position. Exploration and evaluation assets are reviewed for impairment prior to any such transfer. Assets classified as exploration and evaluation are not subject to depletion and depreciation until they are reclassified to petroleum and natural gas properties and equipment.

**(e) Petroleum and Natural Gas Properties and Equipment**

*(i) Recognition and measurement*

Petroleum and natural gas properties and equipment are measured at cost less accumulated depletion and depreciation and accumulated impairment losses, if any.

Petroleum and natural gas properties and equipment consists of the purchase price and costs directly attributable to bringing the asset to the location and condition necessary for its intended use. Petroleum and natural gas assets include developing and producing interests such as mineral lease acquisitions, geological and geophysical costs, facility and production equipment and associated turnarounds, other directly attributable administrative costs and the initial estimate of the costs of dismantling and removing an asset and restoring the site on which it was located.

*(ii) Subsequent costs*

Costs incurred subsequent to the determination of technical feasibility and commercial viability are recognized as developing and producing petroleum and natural gas interests when they increase the future economic benefits embodied in the specific asset to which they relate. Such capitalized petroleum and natural gas interests generally represent costs

incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on an area basis. The cost of day-to-day servicing of an item of petroleum and natural gas properties and equipment is expensed in profit or loss as incurred.

Petroleum and natural gas properties and equipment are de-recognized upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising from the disposal of an asset, determined as the difference between the net disposal proceeds and the carrying amount of the asset, is recognized in profit or loss.

*(iii) Asset exchanges*

For exchanges or parts of exchanges that involve only exploration and evaluation assets, the exchange is accounted for at carrying value. Exchanges of development and production assets are measured at fair value, unless the exchange transaction lacks commercial substance or the fair value of the assets given up or the assets received cannot be reliably estimated. The cost of the acquired asset is measured at the fair value of the asset given up, unless the fair value of the asset received is more reliable. Where fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. Any gain or loss on the de-recognition of the asset given up is recognized in profit and loss.

*(iv) Depletion and depreciation*

The net carrying value of developing and producing petroleum and natural gas assets, net of estimated residual value, is depleted on an area basis using the unit of production method. This depletion calculation includes actual production in the period and total estimated proved plus probable reserves attributable to the assets being depreciated, taking into account total capitalized costs plus estimated future development costs necessary to bring those reserves into production. Relative volumes of reserves and production (before royalties) are converted at the energy equivalent conversion ratio of six thousand cubic feet of natural gas to one barrel of oil. These estimates are reviewed by the Corporation's independent reserves evaluator at least annually.

Capitalized plant turnaround costs are depreciated on a straight-line basis over the estimated time until the next turnaround is completed. Corporate assets, which include office furniture and equipment, software, computer equipment and leasehold improvements, are depreciated on a straight-line basis over the estimated useful lives of the assets, which are estimated to be four years.

When significant parts of property and equipment, including petroleum and natural gas interests, have different useful lives, they are accounted for as separate items (major components). Depreciation methods, useful lives and residual values for petroleum and natural gas properties and equipment are reviewed at each reporting date.

**(f) Provisions**

Provisions are recognized when the Corporation has a present obligation (legal or constructive), as a result of a past event, if it is probable that the Corporation will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognized as a provision is the best estimate of the consideration required to settle the present obligation at the end of the reporting period, taking into account the risks and

uncertainties surrounding the obligation. When a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows (where the effect of the time value of money is significant).

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, a receivable is recognized as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

Provisions are not recognized for future operating losses.

#### **(g) Decommissioning Obligations**

The Corporation's activities give rise to dismantling, restoration and site disturbance remediation activities. Costs related to abandonment activities are estimated by management in consultation with the Corporation's independent reserves evaluators based on risk-adjusted current costs which take into consideration current technology in accordance with existing legislation and industry practices.

Decommissioning obligations are measured at the present value of the best estimate of expenditures required to settle the present obligations at the reporting date. When the best estimate of the liability is initially measured, the estimated cost, discounted using a pre-tax risk-free discount rate, is capitalized by increasing the carrying amount of the related petroleum and natural gas properties and equipment. The increase in the provision due to the passage of time, which is referred to as accretion, is recognized as a finance expense. Actual costs incurred upon settlement of the liability are charged against the obligation to the extent that the obligation was previously established. The carrying amount capitalized in petroleum and natural gas properties and equipment is depleted in accordance with the Corporation's depletion and depreciation policy. The Corporation reviews the obligation at each reporting date and revisions to the estimated timing of cash flows, discount rates and estimated costs result in an increase or decrease to the obligations and the related petroleum and natural gas properties and equipment. Any difference between the actual costs incurred upon settlement of the obligation and the recorded liability is recognized as a gain or loss in profit or loss.

#### **(h) Share-Based Payments**

Equity-settled share-based awards granted by the Corporation include stock options and performance warrants granted to officers, directors and employees. The fair value determined at the grant date of an award is expensed on a graded basis over the vesting period of each respective tranche of an award with a corresponding increase to contributed surplus. In calculating the expense of share-based awards, the Corporation revises its estimate of the number of equity instruments expected to vest by applying an estimated forfeiture rate for each vesting tranche and subsequently revising this estimate throughout the vesting period, as necessary, with a final adjustment to reflect the actual number of awards that vest. Upon the exercise of share-based awards, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. In the event that vested share-based awards expire without being exercised, previously recognized compensation costs associated with such awards are not reversed. The expense related to share-based awards is included within administrative expenses in profit or loss.

The fair value of equity-settled share-based awards is measured using the Black-Scholes option-pricing model taking into account the terms and conditions upon which the awards were granted. Measurement inputs as at the grant date include: share price, exercise price, expected volatility

(based on weighted average historical traded daily volatility), weighted average expected life of the instruments (based on historical experience and general option holder behaviour), expected dividends and the risk-free interest rate (based on government bonds) applicable to the term of the award.

A portion of share-based compensation expense directly attributable to the exploration and development of the Corporation's assets are capitalized.

**(i) Finance Income and Expenses**

Finance expenses include interest expense on borrowings, accretion of the discount on decommissioning obligations, amortization of deferred charges and impairment losses (if any) recognized on financial assets. Interest income is recognized as it is earned.

**(j) Borrowing Costs**

Borrowing costs incurred for the acquisition, construction or production of qualifying assets are capitalized during the period of time that is required to complete and prepare the asset for its intended use or sale. Assets are considered to be qualifying assets when this period of time is substantial. The capitalization rate, used to determine the amount of borrowing costs to be capitalized, is the weighted average interest rate applicable to the Corporation's outstanding borrowings during the period. All other borrowing costs are charged to profit or loss using the effective interest method.

**(k) Financial Instruments**

*(i) Non-derivative financial instruments*

Non-derivative financial instruments are comprised of cash, accounts receivable, accounts payable and accrued liabilities, outstanding credit facilities and capital securities. Non-derivative financial instruments are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, non-derivative financial instruments are measured based on their classification. The Corporation has made the following classifications:

- Cash and accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest method. Typically, the fair value of these balances approximates their carrying value due to their short term to maturity.
- Accounts payable and accrued liabilities and outstanding credit facilities are classified as other financial liabilities and are measured at amortized cost using the effective interest method. Due to the short-term nature of accounts payable and accrued liabilities, their carrying values approximate their fair values. The Corporation's outstanding credit facilities bear interest at a floating rate and accordingly the fair market value approximates the carrying value before the carrying value is reduced for any remaining unamortized costs. The interest costs and financing fees associated with the Corporation's credit facilities have been deferred and netted against the amounts drawn, and are being amortized to profit or loss using the effective interest method over the applicable term.
- The proceeds from the issuance of Series C Preferred Shares, which are presented as "capital securities" on the statement of financial position, are classified as "other

financial liabilities” under IFRS. The incremental costs directly attributable to the issuance of Series C Preferred Shares are initially recognized as a reduction to capital securities and subsequently amortized to profit and loss, using the effective interest rate method, as a finance expense. Dividend distributions on capital securities are recorded as an expense directly to profit and loss and presented as a financing activity on the statements of cash flows.

*(ii) Derivative financial instruments*

Derivatives may be used by the Corporation to manage economic exposure to market risk relating to commodity prices. Birchcliff’s policy is not to utilize derivative financial instruments for speculative purposes. The Corporation does not designate its financial derivative contracts as hedges, and as such does not apply hedge accounting. As a result, financial derivatives are classified at fair value through profit or loss and are recorded on the statements of financial position at fair value.

The fair value of commodity price risk management contracts is determined by discounting the difference between the contracted prices and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate (based on published government rates). The fair value of options and costless collars is based on option models that use published information with respect to volatility, prices and interest rates.

The Corporation accounts for any forward physical delivery sales contracts, which were entered into and continue to be held for the purpose of receipt or delivery of non-financial items, in accordance with its expected purchase, sale or usage requirements as executory contracts. As such, these contracts are not considered to be derivative financial instruments and have not been recorded at fair value on the statements of financial position. Settlements on physical sales contracts are recognized in petroleum and natural gas sales in profit and loss.

*(iii) Share capital*

Common shares and perpetual preferred shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a reduction in share capital, net of any tax effects.

**(I) Impairment**

*(i) Impairment of financial assets*

Financial assets are assessed at each reporting 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.

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. Impairment losses are recognized in profit or loss. An impairment loss is

reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized.

*(ii) Impairment of non-financial assets*

The Corporation's petroleum and natural gas properties and equipment are grouped into Cash Generating Units ("CGUs") for the purpose of assessing impairment. A CGU represents the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets.

CGUs are reviewed at each reporting date for indicators of potential impairment. Such indicators may include, but are not limited to, changes in the Corporation's business plan, deterioration in commodity prices or a significant downward revision of estimated recoverable reserves. If indicators of asset impairment exist, an impairment test is performed by comparing a CGU's carrying value to its recoverable amount. A CGU's recoverable amount is the greater of its fair value less cost to sell and its current value in use. The calculation of the recoverable amount is sensitive to the assumptions regarding production volumes, discount rates and commodity prices. Any excess of carrying value over recoverable amount is recognized as impairment loss in profit or loss.

In assessing the value in use, the estimated future cash flows from proved and probable reserves are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money. Fair value is determined as the amount that would be obtained from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. The petroleum and natural gas future prices used in the impairment test are based on period-end commodity price forecasts estimated by the Corporation's independent reserves evaluator and are adjusted for petroleum and natural gas differentials and transportation and marketing costs specific to the Corporation.

Where circumstances change such that an impairment no longer exists or is less than the amount previously recognized, the carrying amount of the CGU is increased to the revised estimate of its recoverable amount as long as the revised estimate does not exceed the carrying amount that would have been determined, net of depletion and depreciation, had no impairment loss been recognized for the CGU in prior periods. A reversal of an impairment loss is recognized immediately through profit or loss.

Exploration and evaluation assets are assessed for impairment if: (i) sufficient data exists to determine technical feasibility and commercial viability of an exploration area, or (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For purposes of impairment testing, exploration and evaluation assets are allocated to CGUs.

**(m) Income Taxes**

Birchcliff is a corporation as defined under the *Income Tax Act* (Canada) and is subject to Canadian Federal and provincial taxes. Birchcliff is subject to provincial taxes in Alberta as the Corporation operates in this jurisdiction. The Corporation's income tax expenses include current and/or deferred tax. Income tax expense is recognized through profit or loss except to the extent that it relates to items recognized directly in equity, in which case the related income taxes are also recognized in equity.

Current tax is the expected tax payable on taxable income and Part VI.I dividend tax payable on taxable preferred shares for the period, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable income. Deferred tax liabilities are generally recognized for all taxable temporary differences. Deferred tax assets are generally recognized for all deductible temporary differences to the extent that it is probable that taxable income will be available against which those deductible temporary differences can be utilized. The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable income will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is expected to be settled or the asset realized, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which Birchcliff expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

#### **(n) Capital Securities**

The issuance of Series C Preferred Shares, which are presented as “capital securities” on the statements of financial position, are classified as “other financial liabilities” under IFRS. The incremental costs directly attributable to the issuance of Series C Preferred Shares are initially recognized as a reduction to capital securities and subsequently amortized to profit and loss, using the effective interest rate method, as a finance expense. Dividend distributions on capital securities are recorded as an expense directly to profit and loss and presented as a financing activity on the statements of cash flows.

#### **(o) Flow-Through Shares**

The Corporation may issue flow-through shares to finance a portion of its capital expenditure program. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures are renounced to the subscribers. The difference between the value ascribed to flow-through shares issued and the value that would have been received for common shares at the date of announcements of the flow-through shares is initially recognized as a liability on the statements of financial position. When the expenditures are incurred, the liability is drawn down, a deferred tax liability is recorded equal to the estimated amount of deferred income tax payable by the Corporation as a result of the renunciation and the difference is recognized as a deferred tax expense.

#### **(p) Per Common Share**

The Corporation calculates per common share amounts using net income available to Birchcliff’s shareholders, reduced for perpetual preferred share dividends and divided by the weighted average number of common shares outstanding. Basic per share information is computed using the weighted average number of basic common shares outstanding during the period. Diluted per share information is calculated using the treasury stock method, which assumes that any proceeds from the exercise of “in-the-money” stock options, performance warrants or warrants (the “**Securities**”), plus the unamortized stock-based compensation expense amounts, would be used

to purchase common shares at the average market price during the period. No adjustment to diluted earnings per share is made if the result of these calculations is anti-dilutive. The average market value of the Corporation's shares for the purpose of calculating the dilutive effect is based on average quoted market prices for the time that the Securities were outstanding during the period.

**(q) Business Combinations**

The purchase method of accounting is used to account for acquisitions of businesses 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 and liabilities incurred or assumed at the date of exchange. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. If the consideration given up is less than the fair value of the net assets received, the difference is recognized immediately in the income statement. If the consideration is greater than the fair value of the net assets received, the difference is recognized as goodwill on the statement of financial position. Acquisition costs incurred are expensed.

**(r) Critical Accounting Judgments and Key Sources of Estimation Uncertainty**

The timely preparation of the financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets and liabilities and income and expenses. Accordingly, actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

*Critical judgments in applying accounting policies:*

The following are the critical judgments that management has made in the process of applying the Corporation's accounting policies and that have the most significant effect on the amounts recognized in these financial statements:

*(i) Identification of cash-generating units*

Birchcliff's assets are required to be aggregated into CGUs for the purpose of calculating impairment based on their ability to generate largely independent cash inflows. CGUs have been determined based on similar geological structure, shared infrastructure, geographical proximity, operating structure, commodity type and similar exposures to market risks. By their nature, these assumptions are subject to management's judgment and may impact the carrying value of the Corporation's assets in future periods.

*(ii) Identification of impairment indicators*

IFRS requires Birchcliff to assess, at each reporting date, whether there are any indicators that its petroleum and natural gas assets may be impaired. Birchcliff is required to consider information from both external sources (such as negative downturn in commodity prices, significant adverse changes in the technological, market, economic or legal environment in which the entity operates) and internal sources (such as downward revisions in reserves, significant adverse effect on the financial and operational performance of a CGU, evidence of obsolescence or physical damage to the asset). By their nature, these assumptions are subject to management's judgment.

*(iii) Tax uncertainties*

IFRS requires Birchcliff, at each reporting date, to make certain judgments on uncertain tax positions by relevant tax authorities. Judgments include determining whether the Corporation will “more likely than not” be successful in defending its tax positions by considering information from relevant tax interpretations and tax laws in Canada. As such, this recognition threshold is subject to management’s judgment and may impact the carrying value of the Corporation’s deferred tax assets and liabilities at the end of the reporting period.

*Key sources of estimation uncertainty:*

The following are the key assumptions concerning the sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing adjustments to the carrying amounts of assets and liabilities within the next financial year:

*(i) Reserves*

Reported recoverable quantities of proved and probable reserves requires estimation regarding production profile, commodity prices, exchange rates, remediation costs, timing and amount of future development costs, and production, transportation and marketing costs for future cash flows. It also requires interpretation of geological and geophysical models in order to make an assessment of the size, shape, depth and quality of reservoirs, and their anticipated recoveries. The economical, geological and technical factors used to estimate reserves may change from period to period. Changes in reported reserves can impact the carrying values of the Corporation’s petroleum and natural gas properties and equipment, the calculation of depletion and depreciation, the provision for decommissioning obligations, and the recognition of deferred tax assets due to changes in expected future cash flows. The recoverable quantities of reserves and estimated cash flows from Birchcliff’s petroleum and natural gas interests are independently evaluated by reserve engineers at least annually.

The Corporation’s petroleum and natural gas reserves represent the estimated quantities of petroleum, natural gas and NGLs which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be economically recoverable in future years from known reservoirs and which are considered commercially producible. Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon (i) a reasonable assessment of the future economics of such production; (ii) a reasonable expectation that there is a market for all or substantially all the expected petroleum and natural gas production; and (iii) evidence that the necessary production, transmission and transportation facilities are available or can be made available. Reserves may only be considered proved and probable if producibility is supported by either production or conclusive formation tests. Birchcliff’s oil and gas reserves are determined in accordance with the standards contained in National Instrument 51-101 – *Standards of Disclosure for Oil and Gas Activities* and the *Canadian Oil and Gas Evaluation Handbook*.

*(ii) Share-based payments*

All equity-settled, share-based awards issued by the Corporation are fair valued using the Black-Scholes option-pricing model. In assessing the fair value of equity-based

compensation, estimates have to be made regarding the expected volatility in share price, option life, dividend yield, risk-free rate and estimated forfeitures at the initial grant date.

*(iii) Decommissioning obligations*

The Corporation estimates future remediation costs of production facilities, wells and pipelines at different stages of development and construction of assets or facilities. In most instances, removal of assets occurs many years into the future. This requires an estimate regarding abandonment date, future environmental and regulatory legislation, the extent of reclamation activities, the engineering methodology for estimating cost, future removal technologies in determining the removal cost and liability-specific discount rates to determine the present value of these cash flows.

*(iv) Impairment of non-financial assets*

For the purposes of determining the extent of any impairment or its reversal, estimates must be made regarding future cash flows taking into account key assumptions including future petroleum and natural gas prices, expected forecasted 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 amount of the Corporation's assets, and impairment charges and reversal will affect profit or loss.

*(v) Income taxes*

Birchcliff files corporate income tax, goods and service tax and other tax returns with various provincial and federal taxation authorities in Canada. There can be differing interpretations of applicable tax laws and regulations. The resolution of these tax positions through negotiations or litigation with tax authorities can take several years to complete. The Corporation does not anticipate that there will be any material impact upon the results of its operations, financial position or liquidity.

Tax provisions are based on enacted or substantively enacted laws. Changes in those laws could affect amounts recognized in profit or loss both in the period of change, which would include any impact on cumulative provisions, and in future periods.

Deferred tax assets (if any) are recognized only to the extent it is considered probable that those assets will be recoverable. This involves an assessment of when those deferred tax assets are likely to reverse and a judgment as to whether or not there will be sufficient taxable profits available to offset the tax assets when they do reverse. This requires assumptions regarding future profitability and is therefore inherently uncertain. Estimates of future taxable income are based on forecasted cash flows from operations. To the extent that any interpretation of tax law is challenged by the tax authorities or future cash flows and taxable income differ significantly from estimates, the ability of Birchcliff to realize the deferred tax assets recorded at the balance sheet date could be impacted.

## 4. CHANGES IN ACCOUNTING POLICIES

### Future Accounting Pronouncements

In January 2016, the IASB issued IFRS 16 *Leases*. The standard will be effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted, provided IFRS 15 Revenue from Contracts with Customers, has been applied, or is applied at the same date as IFRS 16. Birchcliff is currently evaluating the impact of adopting IFRS 16 on the financial statements.

In April 2016, the IASB issued amendments to IAS 7 *Statement of Cash Flows* for annual periods beginning on or after January 1, 2017, with earlier application permitted. The amendments require entities to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. Birchcliff is currently evaluating the impact of the amendments on the financial statements.

In May 2014, the IASB issued IFRS 15 *Revenue From Contracts With Customers* replacing IAS 11 *Construction Contracts*, IAS 18 *Revenue* and several revenue-related interpretations. IFRS 15 contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. Birchcliff is currently assessing the impact of adopting IFRS 15; however, it anticipates that this standard will not have a material impact on the Corporation's financial statements.

In July 2014, the IASB issued the final version of IFRS 9 *Financial Instruments* to replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 aligns hedge accounting more closely with risk management. The new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognize ineffectiveness. However, under the new standard, more hedging strategies that are used for risk management will qualify for hedge accounting. IFRS 9 is effective for years beginning on or after January 1, 2018. As the Corporation does not currently apply hedge accounting it anticipates that this standard will not have a material impact on the Corporation's financial statements.

## 5. EXPLORATION AND EVALUATION ASSETS

The continuity for exploration and evaluation (“E&E”) assets are as follows:

| (\$000s)                       | E&E <sup>(1)</sup> |
|--------------------------------|--------------------|
| As at December 31, 2014        | 2,235              |
| Additions                      | 117                |
| Disposals                      | (1)                |
| Lease expiries                 | (2,104)            |
| As at December 31, 2015        | 247                |
| Additions                      | 46                 |
| Lease expiries <sup>(2)</sup>  | (240)              |
| <b>As at December 31, 2016</b> | <b>53</b>          |

(1) E&E assets consist of the Corporation's exploration activities which are pending the determination of economic quantities of commercially producible proved reserves. Additions represent the Corporation's net share of costs incurred on E&E activities during the period. A review of each exploration project by area is carried out at each reporting date to ascertain whether economical quantities of proved reserves have been discovered and whether such costs should be transferred to depletable petroleum and natural gas components. There were no exploration costs reclassified from the E&E category to petroleum and natural gas properties and equipment category during 2016 and 2015.

(2) For the year ended December 31, 2016, the Corporation incurred an expense of approximately \$0.24 million related to lease expiries on undeveloped land that has been included as a loss on sale of assets in profit or loss.

## 6. PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

The continuity for petroleum and natural gas (“P&NG”) properties and equipment are as follows:

| <i>(\$000s)</i>                                   | <b>P&amp;NG<br/>Assets</b> | <b>Corporate<br/>Assets</b> | <b>Total</b>     |
|---|----------------------------|-----------------------------|------------------|
| <i>Cost:</i>                                      |                            |                             |                  |
| As at December 31, 2014                           | 2,325,501                  | 10,220                      | 2,335,721        |
| Additions   | 267,711                    | 749                         | 268,460          |
| Dispositions                                      | (4,862)                    | -                           | (4,862)          |
| As at December 31, 2015                           | 2,588,350                  | 10,969                      | 2,599,319        |
| Additions   | 190,546                    | 2,981                       | 193,527          |
| Acquisitions <sup>(1)</sup>                       | 634,345                    | -                           | 634,345          |
| Dispositions <sup>(2)</sup>                       | (37,005)                   | -                           | (37,005)         |
| As at December 31, 2016 <sup>(3)</sup>            | 3,376,236                  | 13,950                      | 3,390,186        |
| <i>Accumulated depletion and depreciation:</i>    |                            |                             |                  |
| As at December 31, 2014                           | (449,409)                  | (6,464)                     | (455,873)        |
| Depletion and depreciation expense                | (143,181)                  | (1,185)                     | (144,366)        |
| As at December 31, 2015                           | (592,590)                  | (7,649)                     | (600,239)        |
| Depletion and depreciation expense <sup>(4)</sup> | (147,837)                  | (1,532)                     | (149,369)        |
| Dispositions <sup>(2)</sup>                       | 5,206                      | -                           | 5,206            |
| As at December 31, 2016                           | (735,221)                  | (9,181)                     | (744,402)        |
| <i>Net book value:</i>                            |                            |                             |                  |
| As at December 31, 2015                           | 1,995,760                  | 3,320                       | 1,999,080        |
| <b>As at December 31, 2016<sup>(5)</sup></b>      | <b>2,641,015</b>           | <b>4,769</b>                | <b>2,645,784</b> |

(1) In July 2016, Birchcliff acquired certain petroleum and natural gas properties, interests and related assets primarily located in the Gordondale area of Alberta. See “Business Combination” below.

(2) Consists largely of non-core asset dispositions in the Progress, Grande Prairie and Gordondale areas with combined net book values of \$31.4 million for net proceeds of \$19.9 million.

(3) The Corporation’s P&NG properties and equipment were pledged as security for its credit facilities. Although the Corporation believes that it has title to its P&NG properties, it cannot control or completely protect itself against the risk of title disputes and challenges. There were no borrowing costs capitalized to P&NG properties and equipment.

(4) Future development costs required to develop and produce proved plus probable reserves totalled \$4.1 billion at the end of 2016 (2015 – \$3.1 billion) and are included in the depletion expense calculation.

(5) Birchcliff performed an impairment assessment of its P&NG assets on a CGU basis and determined there were no impairment triggers identified at the end of the reporting periods. As a result, no impairment test was required as at December 31, 2016.

### Business Combination

On July 28, 2016, Birchcliff acquired significant petroleum and natural gas properties and related assets located in the Gordondale area of Alberta from Encana Corporation (the “Gordondale Acquisition”). The assets acquired were immediately adjacent to Birchcliff’s existing Pouce Coupe properties. The Gordondale Acquisition resulted in a significant increase in production and processing capacity, along with allowing the Corporation to leverage operational synergies created from having ownership in key assets.

The cash purchase price of approximately \$613.5 million (after adjustments) for the Gordondale Acquisition was primarily funded through the issuance of 110,520,000 subscription receipts at a price of \$6.25 (see Note 10, “Capital Stock”).

Results from operations are included in the Corporation’s financial statements from the closing date of the transaction. The Gordondale Acquisition has been accounted for using the purchase method based on fair values as set forth below:

(\$000s)

|  |                |
|--|----------------|
| Fair value of net assets acquired:                 |                |
| Prepaid expenses                                   | 1,206          |
| Petroleum and natural gas properties and equipment | 632,387        |
| Decommissioning obligations                        | (20,072)       |
| <b>Total</b>                                       | <b>613,521</b> |
| Consideration:                                     |                |
| <b>Cash consideration</b>                          | <b>613,521</b> |

The fair value attributed to the petroleum and natural gas properties and equipment acquired was supported by an independent reserve engineering report using proved plus probable reserves discounted at a rate based on what a market participant would pay as well as market metrics for similar assets. The fair value of decommissioning obligations was initially estimated using a credit-adjusted rate of 7%.

Included in the statements of net loss and comprehensive loss for the year ended December 31, 2016 are the following amounts relating to the Gordondale Acquisition since July 28, 2016:

(\$000s)

|                                     |        |
|-------------------------------------|--------|
| Petroleum and natural gas revenue   | 84,789 |
| Net income and comprehensive income | 10,530 |

If the Gordondale Acquisition had occurred on January 1, 2016, the pro-forma results of petroleum and natural gas sales and net loss and comprehensive loss for the year ended December 31, 2016 is set forth below:

| (\$000s)                        | As<br>Stated | Gordondale<br>Acquisition | Pro Forma<br>December 31, 2016 |
|---------------------------------|--------------|---------------------------|--------------------------------|
| Petroleum and natural gas sales | 337,586      | 95,740                    | 433,326                        |
| Net loss and comprehensive loss | (24,335)     | (4,072)                   | (28,407)                       |

## 7. REVOLVING TERM CREDIT FACILITIES

The components of the Corporation's revolving credit facilities include:

| As at December 31, (\$000s)                          | 2016           | 2015           |
|--|----------------|----------------|
| Syndicated credit facility                           | 569,000        | 607,000        |
| Working capital facility                             | 11,770         | 23,037         |
| Drawn revolving term credit facilities               | 580,770        | 630,037        |
| Unamortized prepaid interest on bankers' acceptances | (6,621)        | (6,347)        |
| Unamortized deferred financing fees                  | (1,632)        | (1,616)        |
| <b>Revolving term credit facilities</b>              | <b>572,517</b> | <b>622,074</b> |

On July 28, 2016, in connection with the closing of the Gordondale Acquisition, the Corporation's extendible revolving credit facilities (the "**Credit Facilities**") were amended to increase the borrowing base to \$950 million from \$750 million. After giving effect to the increase in the borrowing base, the Credit Facilities are comprised of: (i) an extendible revolving syndicated term credit facility of \$900 million (the "**Syndicated Credit Facility**"); and (ii) an extendible revolving working capital credit facility of \$50 million (the "**Working Capital Facility**").

The Credit Facilities allow for prime rate loans, London Inter Bank Offered Rate (LIBOR) loans, U.S. base rate loans, bankers' acceptances and, in the case of the Working Capital Facility only, letters of credit. The interest rates applicable to the drawn loans are based on a pricing margin grid and will change as a result of the ratio of outstanding indebtedness to EBITDA as calculated in accordance with the agreement governing the Credit Facilities. EBITDA is defined as earnings before interest and non-cash

items, including (if any) income taxes, stock-based compensation, gains and losses on sale of assets, unrealized gains and losses on financial instruments and depletion, depreciation and amortization.

The Credit Facilities are subject to a semi-annual review of the borrowing base limit by Birchcliff's syndicate of lenders, which limit is directly impacted by the value of Birchcliff's oil and natural gas reserves. In addition, pursuant to the terms of the credit agreement governing the Credit Facilities, the borrowing base of the Credit Facilities may be adjusted in certain other circumstances. Upon any change in or redetermination of the borrowing base limit which results in a borrowing base shortfall, Birchcliff must eliminate the borrowing base shortfall amount.

The maturity dates of the Credit Facilities are May 11, 2018. Birchcliff may each year, at its option, request an extension to the maturity date of the Syndicated Credit Facility and the Working Capital Facility, or either of them, for an additional period of up to three years from May 11 of the year in which the extension request is made.

The Credit Facilities are secured by a fixed and floating charge debenture and pledge charging substantially all of the Corporation's assets. No fixed charges have been granted pursuant to such debenture. The Credit Facilities do not contain any financial covenants.

## 8. DECOMMISSIONING OBLIGATIONS

The Corporation's decommissioning obligations result from its net ownership interests in petroleum and natural gas assets, including well sites, gathering systems and processing facilities. The Corporation estimates the total undiscounted (inflated) amount of cash flow required to settle its decommissioning obligations is approximately \$266.9 million (December 31, 2015 – \$159.9 million) and is expected to be incurred between 2017 and 2068. A risk-free rate of 2.36% (December 31, 2015 – 2.26%) and an inflation rate of 2.0% (December 31, 2015 – 2.0%) were used to calculate the fair value of the decommissioning obligations.

A reconciliation of the decommissioning obligations is set forth below:

| <b>As at December 31, (\$000s)</b>                    | <b>2016</b>    | <b>2015</b>   |
|---|----------------|---------------|
| Balance, beginning                                    | 92,504         | 85,824        |
| Obligations incurred                                  | 2,772          | 2,086         |
| Obligations acquired <sup>(1)</sup>                   | 20,072         | -             |
| Obligations divested                                  | (1,579)        | (1,170)       |
| Change in discount rate on acquisition <sup>(1)</sup> | 22,599         | -             |
| Changes in estimated future cash flows <sup>(2)</sup> | (4,102)        | 4,422         |
| Accretion expense                                     | 2,547          | 2,235         |
| Actual expenditures                                   | (1,343)        | (893)         |
| <b>Balance, ending</b>                                | <b>133,470</b> | <b>92,504</b> |

(1) The decommissioning obligations acquired in the Gordondale Acquisition were initially recognized using a credit-adjusted discount rate of 7%. They were subsequently revalued using the risk-free rate noted above resulting in the change in discount rate on acquisition of \$22.6 million with the offset to petroleum and natural gas properties and equipment.

(2) Changes in estimated future cash flows largely due to the revision in both the risk-free discount rate and abandonment and reclamation cost and date estimates for Birchcliff's oil and natural gas wells and facilities.

## 9. INCOME TAXES

Included in the income tax recovery for the year ended December 31, 2016 is a deferred income tax recovery totalling \$9.1 million (2015 – \$20.2 million expense) and a Part VI.I dividend tax totalling \$3.0 million (2015 – \$3.0 million) resulting from preferred share dividends paid during the period. For the purposes of determining the current income tax, the Corporation applied a combined Canadian federal and provincial income tax rate of 27% in 2016 (2015 – 26%). For the purposes of determining the

deferred income tax, the Corporation applied a combined Canadian federal and provincial effective income tax rate of 27% in 2016 (2015 – 27%).

The components of income tax recovery (expense) are set forth below:

| <b>Years ended December 31, (\$000s)</b>                    | <b>2016</b>  | <b>2015</b>     |
|---|--------------|-----------------|
| Net income (loss) before taxes                              | (30,461)     | 11,072          |
| Computed expected income tax recovery (expense)             | 8,224        | (2,879)         |
| Decrease (increase) in taxes resulting from:                |              |                 |
| Non-deductible stock-based compensation                     | (844)        | (1,025)         |
| Non-deductible dividends on capital securities              | (945)        | (910)           |
| Non-deductible expenses                                     | (147)        | (93)            |
| Increase in Alberta corporate income tax rates              | -            | (7,759)         |
| Denial of the Veracel tax pools reassessment <sup>(1)</sup> | -            | (10,208)        |
| Other   | (162)        | (358)           |
| <b>Income tax recovery (expense)</b>                        | <b>6,126</b> | <b>(23,232)</b> |

(1) Refer to Note 19.

The components of deferred income tax liabilities are set forth below:

| <b>As at December 31, (\$000s)</b>           | <b>2016</b>   | <b>2015</b>    |
|--|---------------|----------------|
| Deferred income tax liabilities:             |               |                |
| P&NG properties and equipment and E&E assets | 309,741       | 256,004        |
| Deferred financing fees                      | 441           | 436            |
| Capital securities                           | 293           | 376            |
| Deferred income tax assets:                  |               |                |
| Decommissioning obligations                  | (36,037)      | (24,976)       |
| Risk management contracts - liability        | (2,547)       | -              |
| Share issue costs                            | (6,041)       | (520)          |
| Non-capital losses                           | (166,251)     | (115,149)      |
| <b>Deferred income tax liabilities</b>       | <b>99,599</b> | <b>116,171</b> |

A continuity of the net deferred income tax liabilities is set forth below:

| <i>(\$000s)</i>                       | <b>Balance<br/>Jan. 1, 2016</b> | <b>Recognized in<br/>Profit or Loss</b> | <b>Recognized in<br/>Equity</b> | <b>Balance<br/>Dec. 31, 2016</b> |
|---------------------------------------|---------------------------------|---|---------------------------------|----------------------------------|
| P&NG and E&E assets                   | 256,004                         | 53,737                                  | -                               | 309,741                          |
| Deferred financing fees               | 436                             | 5                                       | -                               | 441                              |
| Capital securities                    | 376                             | (83)                                    | -                               | 293                              |
| Decommissioning obligations           | (24,976)                        | (11,061)                                | -                               | (36,037)                         |
| Risk management contracts - liability | -                               | (2,547)                                 | -                               | (2,547)                          |
| Share issue costs                     | (520)                           | 1,925                                   | (7,446)                         | (6,041)                          |
| Non-capital losses                    | (115,149)                       | (51,102)                                | -                               | (166,251)                        |
|                                       | <b>116,171</b>                  | <b>(9,126)</b>                          | <b>(7,446)</b>                  | <b>99,599</b>                    |

| <i>(\$000s)</i>             | <b>Balance<br/>Jan. 1, 2015</b> | <b>Recognized in<br/>Profit or Loss</b> | <b>Balance<br/>Dec. 31, 2015</b> |
|-----------------------------|---------------------------------|---|----------------------------------|
| P&NG and E&E assets         | 185,007                         | 70,997                                  | 256,004                          |
| Deferred financing fees     | 321                             | 115                                     | 436                              |
| Capital securities          | 426                             | (50)                                    | 376                              |
| Decommissioning obligations | (21,456)                        | (3,520)                                 | (24,976)                         |
| Share issue costs           | (885)                           | 365                                     | (520)                            |
| Non-capital losses          | (67,472)                        | (47,677)                                | (115,149)                        |
|                             | <b>95,941</b>                   | <b>20,230</b>                           | <b>116,171</b>                   |

As at December 31, 2016, the Corporation had approximately \$2.1 billion (2015 - \$1.5 billion) in tax pools available for deduction against future taxable income. Included in this tax basis are estimated non-capital loss carry forwards of approximately \$615 million that expire between 2026 and 2036.

Discretionary tax deductions, including Canadian Development Expenses, Canadian Oil and Gas Property Expense and Capital Cost Allowance, were maximized in the respective tax years in order to reduce Birchcliff's accounting profits into a loss position for tax purposes.

## 10. CAPITAL STOCK

### Share Capital

#### (a) Authorized:

Unlimited number of voting common shares, with no par value.

Unlimited number of preferred shares, with no par value.

The preferred shares may be issued in one or more series and the directors are authorized to fix the number of shares in each series and to determine the designation, rights, privileges, restrictions and conditions attached to the shares of each series.

#### (b) Number of common shares and perpetual preferred shares issued:

The following table sets forth the number of common shares and perpetual preferred shares issued:

| As at December 31, (000s)                                   | 2016    | 2015    |
|---|---------|---------|
| <b>Common Shares:</b>                                       |         |         |
| Outstanding at beginning of period - Jan 1                  | 152,308 | 152,214 |
| Issue of common shares                                      | 110,525 | -       |
| Exercise of stock options                                   | 1,209   | 94      |
| Outstanding at end of period                                | 264,042 | 152,308 |
| <b>Series A Preferred Shares (perpetual)<sup>(1)</sup>:</b> |         |         |
| Outstanding at beginning of period - Jan 1                  | 2,000   | 2,000   |
| Outstanding at end of period                                | 2,000   | 2,000   |

- (1) In August 2012, Birchcliff completed a bought deal equity financing for gross proceeds of \$50 million. The Corporation issued 2,000,000 preferred units at a price of \$25.00 per preferred unit for gross proceeds of \$50 million. Each preferred unit was comprised of one cumulative redeemable five year rate reset Series A Preferred Share of Birchcliff, to yield initially 8% per annum; and three common share purchase warrants of Birchcliff (the "preferred warrants"). Each preferred warrant provided the right to purchase one common share until August 8, 2014, at an exercise price of \$8.30 per common share.

The Series A Preferred Shares pay cumulative dividends of \$2.00 per Series A Preferred Share per annum, payable quarterly if, as and when declared by Birchcliff's Board of Directors, for the initial five year period ending September 30, 2017. Thereafter, the dividend rate will be reset every five years at a rate equal to the then current five year Government of Canada bond yield plus 6.83%. The Series A Preferred Shares are redeemable at \$25.00 per preferred share at the option of the Corporation on September 30, 2017 and on September 30 in every fifth year thereafter. Holders of the Series A Preferred Shares have the right, at their option, to convert their Series A Preferred Shares into cumulative redeemable floating rate Series B Preferred Shares, subject to certain conditions, on September 30, 2017 and on September 30 in every fifth year thereafter. The holders of the Series B Preferred Shares will be entitled to receive quarterly floating rate cumulative preferential cash dividends, if declared by Birchcliff's Board of Directors, at a rate equal to the sum of the then current 90 day Government of Canada Treasury Bill rate plus 6.83%. In the event of liquidation, dissolution or winding-up of Birchcliff, the holders of the Series A Preferred Shares and Series B Preferred Shares will be entitled to receive \$25.00 per share as well as all accrued unpaid dividends before any amounts will be paid or any assets will be distributed to the holders of any other shares ranking junior to the Series A Preferred Shares and the Series B Preferred Shares. The holders of the Series A Preferred Shares and the Series B Preferred Shares will not be entitled to share in any further distribution of the assets of the Corporation.

### Capital Securities

On June 14, 2013, Birchcliff completed a \$50 million preferred share issue. The Corporation issued 2,000,000 cumulative redeemable Series C Preferred Shares, at a price of \$25.00 per share. The Series C Preferred Shares bear a 7% dividend and their holders are entitled to receive, as and when declared by the Board of Directors of Birchcliff, fixed cumulative preferential cash dividends at an annual rate of \$1.75 per share, payable quarterly.

The Series C Preferred Shares are not redeemable by the Corporation prior to June 30, 2018. On and after June 30, 2018, the Corporation may, at its option, redeem for cash, all or any number of the outstanding Series C Preferred Shares at \$25.75 per share if redeemed before June 30, 2019, at \$25.50

per share if redeemed on or after June 30, 2019 but before June 30, 2020 and at \$25.00 per share if redeemed on or after June 30, 2020, in each case together with all accrued and unpaid dividends to but excluding the date fixed for redemption.

The Series C Preferred Shares are not redeemable by the holders of the preferred shares prior to June 30, 2020. On and after June 30, 2020, a holder of Series C Preferred Shares may, at its option, redeem for cash, all or any number of Series C Preferred Shares held by such holder on the last day of March, June, September and December of each year at \$25.00 per share, together with all accrued and unpaid dividends to but excluding the date fixed for redemption. Upon receipt of the Notice of Redemption, the Corporation may, at its option elect to convert such Series C Preferred Shares into common shares of the Corporation.

On and after June 30, 2018, the Corporation may, at its option, convert all or any number of the outstanding Series C Preferred Shares into common shares.

The Corporation has outstanding 2,000,000 Series C Preferred Shares at December 31, 2016 (2015 – 2,000,000).

### **Issue of Common Shares**

On July 13, 2016, in connection with the Gordondale Acquisition, Birchcliff closed a bought deal financing of 107,520,000 subscription receipts of the Corporation (“**Subscription Receipts**”) at a price of \$6.25 per Subscription Receipt for gross proceeds of \$672.0 million (the “**Public Offering**”) and a concurrent private placement of 3,000,000 Subscription Receipts at a price of \$6.25 per Subscription Receipt for gross proceeds of \$18.8 million (the “**Concurrent Private Placement**”). Gross proceeds from the Public Offering and the Concurrent Private Placement were \$690.8 million.

On July 28, 2016, Birchcliff closed the Gordondale Acquisition and each Subscription Receipt was exchanged for one common share of the Corporation for no additional consideration. The net proceeds of \$663.2 million, after fees payable to the underwriters of the Public Offering, were used to pay the balance of the purchase price for the Gordondale Acquisition, and the remaining balance was used to reduce indebtedness under the Corporation’s Credit Facilities. Birchcliff recognized a deferred income tax benefit of \$7.5 million in respect of share issue costs related to the Public Offering and Concurrent Private Placement totalling approximately \$27.6 million.

### **Dividends**

On November 30, 2016, the Board of Directors declared a quarterly cash dividend of \$1.0 million or \$0.50 per Series A Preferred Share and \$0.875 million or \$0.4375 per Series C Preferred Share for the calendar quarter ending December 31, 2016.

In 2016, cash dividends totalled \$4.0 million or \$2.00 per Series A Preferred Share (2015 - \$4.0 million or \$2.00 per Series A) and \$3.5 million or \$1.75 per Series C Preferred Share (2015 - \$3.5 million or \$1.75 per Series C).

Both dividends are designated as an eligible dividend for the purposes of the *Income Tax Act* (Canada).

## Per Common Share

The following table sets forth the computation of net loss per common share:

| Years Ended December 31,  | 2016          | 2015          |
|---|---------------|---------------|
| Net loss (\$000s)   | 24,335        | 12,160        |
| Dividends on Series A Preferred Shares (\$000s)                   | 4,000         | 4,000         |
| Net loss to common shareholders (\$000s)                          | 28,335        | 16,160        |
| Weighted average common shares (000s):                            |               |               |
| Weighted average basic common shares outstanding                  | 199,581       | 152,286       |
| Effects of dilutive securities                                    | -             | -             |
| Weighted average diluted common shares outstanding <sup>(1)</sup> | 199,581       | 152,286       |
| <b>Net loss per common share</b>                                  |               |               |
| <b>Basic</b>  | <b>\$0.14</b> | <b>\$0.11</b> |
| <b>Diluted</b>  | <b>\$0.14</b> | <b>\$0.11</b> |

(1) As the Corporation reported a loss for the twelve months ended December 31, 2016, the basic and diluted weighted average shares outstanding are the same for the period. The weighted average diluted common shares outstanding as of December 31, 2016 excludes 15,839,507 common shares issuable pursuant to outstanding stock options and performance warrants that are anti-dilutive in the twelve month reporting period (December 31, 2015 – 15,508,970).

## 11. OPERATING EXPENSES

The Corporation's operating expenses include all costs with respect to day-to-day well and facility operations. Processing recoveries related to joint ventures reduces operating expenses. The components of operating expenses are set forth below:

| Years ended December 31, (\$000s) | 2016          | 2015          |
|-----------------------------------|---------------|---------------|
| Field operating costs             | 76,705        | 65,281        |
| Recoveries                        | (1,700)       | (1,500)       |
| Field operating costs, net        | 75,005        | 63,781        |
| Expensed workovers and other      | 246           | 730           |
| <b>Operating expenses</b>         | <b>75,251</b> | <b>64,511</b> |

## 12. ADMINISTRATIVE EXPENSES

The components of administrative expenses are set forth below:

| Years ended December 31, (\$000s)                   | 2016          | 2015          |
|---|---------------|---------------|
| <i>Cash:</i>  |               |               |
| Salaries and benefits <sup>(1)</sup>                | 25,576        | 27,067        |
| Other <sup>(2)</sup>                                | 12,449        | 12,297        |
| General and administrative, gross                   | 38,025        | 39,364        |
| Operating overhead recoveries                       | (154)         | (232)         |
| Capitalized overhead <sup>(3)</sup>                 | (16,382)      | (16,308)      |
| General and administrative, net                     | 21,489        | 22,824        |
| <i>Non-cash:</i>                                    |               |               |
| Stock-based compensation                            | 6,053         | 7,732         |
| Capitalized stock-based compensation <sup>(3)</sup> | (3,575)       | (4,526)       |
| Stock-based compensation, net                       | 2,478         | 3,206         |
| <b>Administrative expenses, net</b>                 | <b>23,967</b> | <b>26,030</b> |

(1) Includes salaries, benefits and bonuses paid to officers and employees of the Corporation.

(2) Includes costs such as rent, legal, tax, insurance, minor computer hardware and software and other business expenses incurred by the Corporation.

- (3) Includes a portion of gross general and administrative expenses and stock-based compensation directly attributable to the exploration and development activities of the Corporation which have been capitalized.

Compensation for the Corporation's executive officers and directors are comprised of the following:

| Years ended December 31, (\$000s)                    | 2016         | 2015         |
|--|--------------|--------------|
| Salaries and benefits <sup>(1)</sup>                 | 6,206        | 6,175        |
| Stock-based compensation <sup>(2)</sup>              | 1,588        | 2,284        |
| <b>Executive Officers and Directors compensation</b> | <b>7,794</b> | <b>8,459</b> |

(1) Includes salaries for the executive officers, directors' fees for the independent directors and benefits earned by executive officers and directors comprising of: the Chairman of the Board, the President and Chief Executive Officer, the Vice-President of Exploration and Chief Operating Officer, the Vice-President and Chief Financial Officer, the Vice-President of Operations, the Vice-President of Engineering, the Vice-President of Corporate Development and the independent directors.

(2) Represents the amortization of stock-based compensation expense in the year associated with options granted to the executive officers and directors participating in the Corporation's Amended and Restated Stock Option Plan.

### 13. FINANCE EXPENSES

The components of finance expenses are set forth below:

| Years ended December 31, (\$000s)        | 2016          | 2015          |
|--|---------------|---------------|
| <i>Cash:</i>                             |               |               |
| Interest on credit facilities            | 30,305        | 22,861        |
| <i>Non-cash:</i>                         |               |               |
| Accretion on decommissioning obligations | 2,547         | 2,235         |
| Amortization of deferred financing fees  | 1,088         | 919           |
| <b>Finance expenses</b>                  | <b>33,940</b> | <b>26,015</b> |

### 14. SHARE-BASED PAYMENTS

#### Stock Options

At December 31, 2016, the Corporation's Amended and Restated Stock Option Plan (the "Option Plan") permitted the grant of options in respect of a maximum of 26,404,190 (December 31, 2015 – 15,230,754) common shares. At December 31, 2016, there remained available for issuance options in respect of 13,504,415 (December 31, 2015 – 2,661,516) common shares. For stock options exercised during 2016, the weighted average common share trading price on the Toronto Stock Exchange was \$7.70 (December 31, 2015 – \$6.42) per common share.

A summary of the outstanding stock options is set forth below:

|   | Number            | Weighted Average Exercise Price (\$) |
|---|-------------------|--------------------------------------|
| Outstanding, December 31, 2014                      | 11,147,672        | 8.45                                 |
| Granted <sup>(1)</sup>                              | 3,358,500         | 6.62                                 |
| Exercised   | (93,333)          | (6.26)                               |
| Forfeited   | (699,201)         | (9.70)                               |
| Expired   | (1,144,400)       | (9.66)                               |
| Outstanding, December 31, 2015                      | 12,569,238        | 7.80                                 |
| Granted <sup>(1)</sup>                              | 3,356,000         | 3.90                                 |
| Exercised   | (1,209,363)       | (6.28)                               |
| Forfeited   | (120,400)         | (6.78)                               |
| Expired   | (1,695,700)       | (11.46)                              |
| <b>Outstanding, December 31, 2016<sup>(1)</sup></b> | <b>12,899,775</b> | <b>6.45</b>                          |

- (1) Each stock option granted entitles the holder to purchase one common share at the exercise price.

The weighted average fair value per option granted during 2016 was \$1.40 (December 31, 2015 – \$2.14). In determining the stock-based compensation expense for options issued during 2016, the Corporation applied a weighted average estimated forfeiture rate of 12% (December 31, 2015 – 13%).

The weighted average assumptions used in calculating the Black-Scholes fair values are set forth below:

| Years Ended December 31, | 2016  | 2015  |
|--------------------------|-------|-------|
| Risk-free interest rate  | 0.6%  | 0.7%  |
| Expected life (years)    | 4.0   | 4.0   |
| Expected volatility      | 45.3% | 40.8% |

A summary of the stock options outstanding and exercisable under the Option Plan at December 31, 2016 is set forth below:

| Exercise Price |         | Awards Outstanding |   |                                 | Awards Exercisable |   |                                 |
|----------------|---------|--------------------|---|---------------------------------|--------------------|---|---------------------------------|
| Low            | High    | Quantity           | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Quantity           | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| \$3.35         | \$6.00  | 4,252,200          | 2.98  | \$4.16                          | 1,233,033          | 0.32  | \$5.96                          |
| \$6.01         | \$9.00  | 8,440,575          | 2.28  | \$7.52                          | 5,187,252          | 1.83  | \$7.68                          |
| \$9.01         | \$12.00 | 204,000            | 2.68  | \$9.96                          | 129,331            | 2.57  | \$9.99                          |
| \$12.01        | \$12.31 | 3,000              | 2.30  | \$12.31                         | 2,000              | 2.30  | \$12.31                         |
|                |         | <b>12,899,775</b>  | <b>2.52</b>                                 | <b>\$6.45</b>                   | <b>6,551,616</b>   | <b>1.56</b>                                 | <b>\$7.40</b>                   |

### Performance Warrants

On January 14, 2005, Birchcliff issued 4,049,665 performance warrants as part of the Corporation's initial restructuring to become a public entity. There are 2,939,732 performance warrants outstanding and exercisable at December 31, 2016 (December 31, 2015 – 2,939,732). Each performance warrant is exercisable at a price of \$3.00 to purchase one common share of Birchcliff and expires on January 31, 2020.

## 15. CAPITAL MANAGEMENT

The Corporation's general policy is to maintain a sufficient capital base in order to manage its business in the most effective manner with the goal of increasing the value of its assets and thus its underlying share value. The Corporation's objectives when managing capital are to maintain financial flexibility in order to preserve its ability to meet financial obligations (including potential obligations arising from additional acquisitions), to maintain a capital structure that allows Birchcliff to finance its growth strategy using primarily internally-generated cash flow and its available debt capacity and to optimize the use of its capital to provide an appropriate investment return to its shareholders. There were no changes in the Corporation's approach to capital management during the year ended December 31, 2016.

The following table sets forth the Corporation's total available credit:

| As at December 31, (\$000s)                        | 2016             | 2015             |
|--|------------------|------------------|
| <i>Maximum borrowing base limit<sup>(1)</sup>:</i> |                  |                  |
| Revolving term credit facilities                   | 950,000          | 800,000          |
| <i>Principal amount utilized:</i>                  |                  |                  |
| Drawn revolving term credit facilities             | (580,770)        | (630,037)        |
| Outstanding letters of credit <sup>(2)</sup>       | (12,310)         | (242)            |
|  | <b>(593,080)</b> | <b>(630,279)</b> |
| <b>Unused credit</b>                               | <b>356,920</b>   | <b>169,721</b>   |

(1) The Credit Facilities are subject to a semi-annual review of the borrowing base limit, which is directly impacted by the value of Birchcliff's petroleum and natural gas reserves. On July 28, 2016, in connection with the closing of the Gordondale Acquisition, the borrowing base was increased to \$950 million.

(2) Letters of credit are issued to various service providers. In connection with the Gordondale Acquisition, the Corporation issued a letter of credit for \$12 million to secure its obligations under various midstream and marketing arrangements. The aforementioned letter of credit has reduced the amount available under the Working Capital Facility from \$50 million to approximately \$38 million. There were no amounts drawn on the letters of credit during 2016 and 2015.

The capital structure of the Corporation is as follows:

| As at December 31, (\$000s)  | 2016             | 2015             | % Change   |
|--|------------------|------------------|------------|
| Shareholders' equity <sup>(1)</sup>  | 1,754,407        | 1,098,434        |            |
| Capital securities   | 48,916           | 48,606           |            |
| Shareholders' equity & capital securities  | <b>1,803,323</b> | <b>1,147,040</b> | <b>57%</b> |
| Shareholders' equity & capital securities as a % of total capital <sup>(2)</sup> | 75%              | 64%              |            |
| Working capital deficit <sup>(3)</sup>   | 27,495           | 21,538           |            |
| Drawn revolving term credit facilities   | 580,770          | 630,037          |            |
| Drawn debt   | 608,265          | 651,575          | (7%)       |
| Drawn debt as a % of total capital   | 25%              | 36%              |            |
| <b>Capital</b>   | <b>2,411,588</b> | <b>1,798,615</b> | <b>34%</b> |

(1) Shareholders' equity is defined as share capital plus contributed surplus plus retained earnings, less any deficit.

(2) Of the 75%, approximately 70% relates to common capital stock and 5% relates to preferred capital stock.

(3) Working capital deficit is defined as current assets less current liabilities (excluding fair value of financial instruments).

## 16. FINANCIAL RISK MANAGEMENT

Birchcliff is exposed to credit risk, liquidity risk and market risk as part of its normal course of business. The Board of Directors has overall responsibility for the establishment and oversight of the Corporation's financial risk management framework and periodically reviews the results of all risk management activities and all outstanding positions.

### Credit Risk

Credit risk is the risk of financial loss to the Corporation if a customer or counterparty to a financial instrument fails to meet its contractual obligation, and arises principally from Birchcliff's receivables from its oil and natural gas marketers. Cash is comprised of bank balances. Historically, the Corporation has not carried short-term investments. Should this change in the future, counterparties will be selected based on credit ratings, management will monitor all investments to ensure a stable return and complex investment vehicles with higher risk will be avoided. The Corporation's exposure to cash credit risk at the balance sheet date is low.

The carrying amount of accounts receivable reflects management's assessment of the credit risk associated with these customers. The following table illustrates the Corporation's maximum exposure for accounts receivable:

| <b>As at December 31, (\$000s)</b> | <b>2016</b>   | <b>2015</b>   |
|------------------------------------|---------------|---------------|
| Marketers <sup>(1)</sup>           | 47,021        | 22,181        |
| Joint venture                      | 373           | 1,229         |
| Other <sup>(2)</sup>               | 15,178        | -             |
| <b>Accounts receivable</b>         | <b>62,572</b> | <b>23,410</b> |

(1) At December 31, 2016, approximately 15% was due from one marketer (2015 – 24%, one marketer). During 2016, the Corporation received 20%, 12%, 12%, 10%, and 10% of its revenue, respectively, from five core marketers (2015 – 20%, 18%, 15%, 15%, 13% and 12% of its revenue, respectively, from six core marketers).

(2) Primarily includes \$6.3 million receivable for leasehold improvements and a \$4.5 million receivable for the final statement of adjustments respecting the Gordondale Acquisition.

Typically, Birchcliff's maximum credit exposure from its marketers is revenue from its commodity sales. Receivables from marketers are normally collected on the 25<sup>th</sup> day of the month following production. Birchcliff mitigates the credit risk associated with these receivables by establishing marketing relationships with credit worthy purchasers, obtaining guarantees from their ultimate parent companies and obtaining letters of credit, as appropriate. The Corporation historically has not experienced any material collection issues with its marketers.

Birchcliff's accounts receivables are aged as follows:

| <b>As at December 31, (\$000s)</b> | <b>2016</b>   | <b>2015</b>   |
|------------------------------------|---------------|---------------|
| Current (less than 30 days)        | 59,733        | 22,569        |
| 30 to 60 days                      | 2,420         | 289           |
| 61 to 90 days                      | 142           | 332           |
| 91 to 120 days                     | 40            | 91            |
| Over 120 days                      | 237           | 129           |
| <b>Accounts receivable</b>         | <b>62,572</b> | <b>23,410</b> |

At December 31, 2016, approximately \$0.2 million or 0.4% (2015 – \$0.1 million or 0.6%) of Birchcliff's total accounts receivable are aged over 120 days and considered past due. The majority of these accounts are due from various joint venture partners. Birchcliff attempts to mitigate the credit risk from joint venture receivables by obtaining pre-approval of significant capital expenditures. However, the receivables are 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 and the risk of unsuccessful drilling. In addition, further risk exists with joint venture partners as disagreements occasionally arise that increases the potential for non-collection. The Corporation does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however, the Corporation does have the ability to withhold production from joint venture partners in the event of non-payment.

The carrying amount of accounts receivable represents the maximum credit exposure. Should Birchcliff determine that the ultimate collection of a financial instrument is in doubt, it will provide the necessary provision in its allowance for doubtful accounts with a corresponding charge to profit or loss. If the Corporation subsequently determines an account is uncollectible, the account is written off with a corresponding charge to the allowance for doubtful accounts. Birchcliff did not have an allowance for doubtful accounts balance at December 31, 2016 and December 31, 2015.

### **Liquidity Risk**

Liquidity risk is the risk that the Corporation will not be able to meet its obligations associated with financial liabilities that are settled by cash as they become due. Birchcliff's approach to managing liquidity is to ensure, as much as possible, that it will have sufficient liquidity to meet its short-term and long-term financial obligations when due, under both normal and unusual conditions without incurring unacceptable losses or risking harm to the Corporation's reputation.

All of the Corporation's contractual financial liabilities can be settled in cash. Typically, the Corporation ensures that it has sufficient cash on demand to meet expected operational expenses, including the servicing of financial obligations. To achieve this objective, the Corporation prepares annual capital expenditure budgets, which are approved by the Board of Directors and are regularly reviewed and updated as considered necessary. Petroleum and natural gas production is monitored daily and is used to provide monthly cash flow estimates. Further, the Corporation utilizes authorizations for expenditures on both operated and non-operated projects to manage capital expenditure. The Corporation also attempts to match its payment cycle with collection of petroleum and natural gas revenue on the 25<sup>th</sup> of each month. Should commodity prices deteriorate materially, Birchcliff may adjust its capital spending accordingly to ensure that it is able to service its short-term financial obligations.

To facilitate the capital expenditure program, the Corporation has an aggregate \$950 million reserve-based bank credit facilities at the end of 2016 (2015 - \$800 million) which are reviewed annually by its lenders (see Note 7). The principal amount drawn under the Corporation's total credit facilities at December 31, 2016 was \$593.1 million (2015 – \$630.3 million) and \$356.9 million in unused credit was available at the end of 2016 (2015 – \$169.7 million) to fund future obligations.

The following table lists the Corporation's financial liabilities at December 31, 2016 in the period they are due:

| <i>(\$000s)</i>                          | <b>2017</b>    | <b>2018</b>    |
|--|----------------|----------------|
| Accounts payable and accrued liabilities | 92,115         | -              |
| Drawn revolving credit facilities        | -              | 580,770        |
| Fair value of financial instruments      | 9,433          | -              |
| <b>Financial liabilities</b>             | <b>101,548</b> | <b>580,770</b> |

### **Market Risk**

Market risk is the risk that changes in market conditions, such as commodity prices, exchange rates and interest rates, will affect the Corporation's net income or the value of its financial instruments, if any. The objective of market risk management is to manage and control exposures within acceptable limits, while maximizing returns. These risks are consistent with prior years. All risk management transactions are conducted within risk management tolerances that are reviewed by the Board of Directors.

### **Commodity Price Risk**

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Significant changes in commodity prices can materially impact cash flows and the Corporation's borrowing base limit. Lower commodity prices can also reduce the Corporation's ability to raise capital. Commodity prices for petroleum and natural gas are not only influenced by Canadian ("CDN") and United States ("US") demand, but also by world events that dictate the levels of supply and demand.

#### *Financial derivative contracts*

During 2016, Birchcliff had certain financial derivative contracts outstanding in order to manage commodity price risk. These instruments are not used for trading or speculative purposes. Birchcliff has not designated its financial derivative contracts as effective accounting hedges, even though the Corporation considers all commodity contracts to be effective economic hedges. As a result, all such financial derivative contracts are recorded on the statement of financial position at fair value, with the changes in fair value being recognized as an unrealized gain or loss in profit or loss.

As at December 31, 2016, the Corporation had the following financial derivatives in place:

| Product                       | Type of Contract | Notional quantity | Term <sup>(1)</sup>                 | Contract price      | Fair value (\$000s) |
|-------------------------------|------------------|-------------------|-------------------------------------|---------------------|---------------------|
| Natural Gas                   | Financial swap   | 40,000 GJ/d       | January 1, 2017 – December 31, 2017 | AECO CDN \$2.97/GJ  | 4,345               |
| Natural Gas                   | Financial swap   | 20,000 GJ/d       | January 1, 2017 – December 31, 2017 | AECO CDN \$2.98/GJ  | 2,042               |
| Natural Gas                   | Financial swap   | 10,000 GJ/d       | October 1, 2017 – December 31, 2017 | AECO CDN \$3.35/GJ  | 19                  |
| Natural Gas                   | Financial swap   | 10,000 GJ/d       | October 1, 2017 – December 31, 2017 | AECO CDN \$3.40/GJ  | (17)                |
| Crude oil                     | Financial swap   | 1,500 bbls/d      | January 1, 2017 – December 31, 2017 | WTI CDN \$69.90/bbl | 3,044               |
| <b>Fair value liabilities</b> |                  |                   |                                     |                     | <b>9,433</b>        |

(1) Transactions with common terms and the same counterparty have been aggregated and presented at the weighted average price, where applicable.

The fair value liability of the Corporation's financial derivative contracts at December 31, 2016 was \$9.4 million (2015 – NIL). As of December 31, 2016, if the future strip prices for AECO natural gas had been CDN\$0.10/GJ higher, with all other variables held constant, the after tax net loss in 2016 would have increased by \$2.4 million. As of December 31, 2016, if the future strip prices for WTI crude oil had been CDN\$1.00/bbl higher, with all other variables held constant, after tax net loss in 2016 would have increased by \$0.4 million.

The following table provides a summary of the realized gain and unrealized loss on financial derivative contracts:

| Years ended December 31, (\$000s) | 2016    | 2015 <sup>(1)</sup> |
|-----------------------------------|---------|---------------------|
| Realized gain on derivatives      | 802     | -                   |
| Unrealized (loss) on derivatives  | (9,433) | -                   |

(1) During 2015, the Corporation did not have any financial derivative contracts in place.

There were no financial derivative contracts entered into subsequent to December 31, 2016.

#### *Physical delivery sales contracts*

Birchcliff also enters into physical delivery sales contracts to manage commodity price risk. These contracts are considered normal executory sales contracts and are not recorded at fair value through profit or loss. At December 31, 2016, the Corporation had the following physical sales contracts in place:

| Product     | Type of Contract | Volume      | Term <sup>(1)</sup>                 | Contract price    |
|-------------|------------------|-------------|-------------------------------------|-------------------|
| Natural Gas | Fixed price      | 20,000 GJ/d | January 1, 2017 – December 31, 2017 | AECO CDN\$2.99/GJ |
| Natural Gas | Fixed price      | 20,000 GJ/d | January 1, 2017 – December 31, 2017 | AECO CDN\$2.98/GJ |
| Natural Gas | Fixed price      | 20,000 GJ/d | January 1, 2017 – December 31, 2017 | AECO CDN\$3.00/GJ |
| Natural Gas | Fixed price      | 10,000 GJ/d | January 1, 2017 – December 31, 2017 | AECO CDN\$3.00/GJ |
| Natural Gas | Fixed price      | 50,000 GJ/d | January 1, 2017 – December 31, 2017 | AECO CDN\$3.05/GJ |
| Natural Gas | Fixed price      | 10,000 GJ/d | Oct 1, 2017 – December 31, 2017     | AECO CDN\$3.35/GJ |

(1) Transactions with common terms and the same counterparty have been aggregated and presented at the weighted average price, where applicable.

There were no physical delivery sales contracts entered into subsequent to December 31, 2016.

### **Foreign Currency Risk**

Foreign currency risk is the risk that future cash flows will fluctuate as a result of changes in foreign currency exchange rates. The exchange rate effect cannot be quantified but generally an increase in the value of the CDN dollar as compared to the US dollar will reduce the prices received by Birchcliff for its petroleum and natural gas sales. The Corporation had no forward exchange rate contracts in place as at or during the years ended December 31, 2016 and 2015.

### **Interest Rate Risk**

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Corporation's credit facilities are exposed to interest rate cash flow risk on a floating interest rate due to fluctuations in market interest rates. The remainder of Birchcliff's financial assets and liabilities are not exposed directly to interest rate risk.

A 1% change in the CDN prime interest rate in 2016 would have changed after-tax net income by approximately \$4.6 million (2015 - \$4.3 million), assuming that all other variables remain constant. A sensitivity of 1% is considered reasonable given the current level of the bank prime rate and market expectations for future movements. The Corporation considers this risk to be limited and thus does not enter into contracts to mitigate its interest rate risk. The Corporation had no interest rate swap contracts in place as at or during the years ended December 31, 2016 and 2015.

### **Fair Value of Financial Instruments**

Birchcliff's financial instruments include cash, accounts receivable, accounts payable and accrued liabilities, financial derivative contracts, outstanding credit facilities and capital securities. All of Birchcliff's financial instruments are transacted in active markets. Financial instruments carried at fair value are assessed using the following hierarchy based on the amount of observable inputs used to value the instrument:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

Assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the placement within the fair value hierarchy level. The carrying value and fair value of the Corporation's financial assets and liabilities at December 31, 2016 are set forth below:

| <i>(\$000s)</i>                                    | <b>Carrying Value</b> | <b>Fair Value</b> |
|--|-----------------------|-------------------|
| <i>Loans and receivables:</i>                      |                       |                   |
| Cash   | 47                    | 47                |
| Accounts receivable                                | 62,572                | 62,572            |
| <i>Other liabilities:</i>                          |                       |                   |
| Accounts payable and accrued liabilities           | 92,115                | 92,115            |
| Fair value of financial derivatives <sup>(1)</sup> | 9,433                 | 9,433             |
| Capital Securities                                 | 48,916                | 50,400            |
| Drawn revolving credit facilities                  | 572,517               | 572,517           |

(1) Financial derivative contracts are fair valued based on level 2.

## 17. COMMITMENTS

The Corporation enters into contracts and commitments in the normal course of operations. The following table lists Birchcliff's commitments at December 31, 2016:

| <i>(\$000s)</i>  | <b>2017</b>   | <b>2018</b>    | <b>2019 - 2021</b> | <b>Thereafter</b> |
|--|---------------|----------------|--------------------|-------------------|
| Operating leases <sup>(1)</sup>                                  | 3,206         | 4,117          | 13,625             | 29,317            |
| Capital commitments <sup>(2)</sup>                               | 36,128        | 16,849         | -                  | -                 |
| Firm transportation, processing and fractionation <sup>(3)</sup> | 36,315        | 105,179        | 294,158            | 294,980           |
| <b>Commitments</b>   | <b>75,649</b> | <b>126,145</b> | <b>307,783</b>     | <b>324,297</b>    |

(1) The Corporation is committed under its existing operating lease relating to its office premises beginning December 1, 2007 which expires on November 30, 2017. On December 2, 2015, the Corporation entered into an operating lease commitment relating to a new office premise beginning February 1, 2018 and expiring on January 31, 2028. The commitment amount under the new 10 year office lease is estimated to be \$47.1 million, which includes costs allocated to base rent, parking and building operating expenses. The office lease commitment amounts disclosed in the above table have not been reduced for any rents receivable by the Corporation.

(2) Includes drilling commitments and facility spending commitments relating to the Phase V and VI expansions of the PC Gas Plant.

(3) As a result of the Gordondale Acquisition, Birchcliff's firm transportation, processing and fractionation obligations have increased as at December 31, 2016.

## 18. SUPPLEMENTARY CASH FLOW INFORMATION

| <b>Years ended December 31, (\$000s)</b> | <b>2016</b>  | <b>2015</b>     |
|--|--------------|-----------------|
| <i>Provided by (used in):</i>            |              |                 |
| Accounts receivable                      | (39,162)     | 11,521          |
| Prepaid expenses and deposits            | 577          | (967)           |
| Accounts payable and accrued liabilities | 44,531       | (65,556)        |
| Dividend tax                             | (3,000)      | (3,166)         |
|  | <b>2,946</b> | <b>(58,168)</b> |
| <i>Provided by (used in):</i>            |              |                 |
| Operating                                | (5,586)      | (11,066)        |
| Investing                                | 8,532        | (47,102)        |
|  | <b>2,946</b> | <b>(58,168)</b> |

## 19. CONTINGENT LIABILITY

Birchcliff's 2006 income tax filings were reassessed by the Canada Revenue Agency (the "CRA") in 2011 (the "Reassessment"). The Reassessment was based on the CRA's position that the tax pools available to Veracel Inc. ("Veracel"), prior to its amalgamation with Birchcliff, ceased to be available to Veracel after Birchcliff and Veracel amalgamated on May 31, 2005. The Veracel tax pools in dispute totalled \$39.3

million, which includes approximately \$16.2 million in non-capital losses, \$15.6 million in scientific research and experimental development expenditures and \$7.5 million in investment tax credits.

Birchcliff appealed the Reassessment to the Tax Court of Canada (the “**Trial Court**”) and the trial of that appeal occurred in November 2013. On October 1, 2015, the Trial Court issued its decision (the “**Trial Decision**”) and dismissed Birchcliff’s appeal on the basis of the general anti-avoidance rule contained in the *Income Tax Act* (Canada). Birchcliff appealed the Trial Decision to the Federal Court of Appeal. The appeal was heard in January 2017 and the Corporation is currently awaiting a decision.

While management continues to believe that its tax position is supportable, in the fourth quarter of 2015 Birchcliff recorded a deferred income tax expense in the amount of \$10.2 million as a result of the Trial Decision being rendered. This Trial Decision did not result in any cash taxes payable by Birchcliff.