

Condensed Consolidated Interim Statements of Financial Position

Stated in thousand of dollars

(Unaudited)

As at	June 30, 2017	December 31, 2016
Assets		
Current Assets		
Accounts receivable	\$ 31,491	\$ 29,511
Fair value of financial contracts (note 5)	4,118	—
Prepaid expenses and deposits	4,646	2,888
	40,255	32,399
Fair value of financial contracts (note 5)	1,020	—
Exploration and evaluation assets (note 3)	7,828	7,828
Petroleum and natural gas properties (note 4)	1,119,956	1,041,151
Deferred income taxes	28,161	33,879
	\$ 1,197,220	\$ 1,115,257
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 26,466	\$ 32,039
Dividends payable	1,787	1,411
Fair value of financial contracts (note 5)	37	12,129
Current portion of other long term obligations	1,804	1,406
	30,094	46,985
Fair value of financial contracts (note 5)	—	922
Bank debt (note 6)	215,945	160,684
Decommissioning obligations (note 7)	154,948	120,025
Other long term obligations	7,068	7,464
Shareholders' equity		
Share capital	1,274,208	1,274,195
Contributed surplus	46,273	41,110
Warrants	3,522	3,522
Deficit	(534,838)	(539,650)
	789,165	779,177
	\$ 1,197,220	\$ 1,115,257

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

Condensed Consolidated Interim Statements of Income (Loss) and Comprehensive Income (Loss)

Stated in thousands of dollars, except per share amounts

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenues				
Petroleum and natural gas	\$ 60,773	\$ 40,943	\$ 115,223	\$ 70,089
Royalties	(7,680)	(3,626)	(14,717)	(7,456)
Realized gain (loss) on financial contracts	(1,029)	3,822	(3,019)	7,804
Unrealized gain (loss) on financial contracts (note 5)	7,164	(9,025)	18,153	(1,495)
	59,228	32,114	115,640	68,942
Expenses				
Operating	17,866	14,062	35,271	29,026
Transportation	2,033	1,288	3,991	4,131
General and administrative	2,680	2,193	5,089	4,588
Transaction costs	459	44	1,017	230
Stock-based compensation (note 8)	495	3,154	545	4,287
Depletion and depreciation (note 4)	22,475	19,271	43,200	40,864
Finance expense	3,387	2,242	6,182	4,638
Loss (gain) on disposal of petroleum and natural gas properties (note 4)	34	—	34	(4,397)
	49,429	42,254	95,329	83,367
Income (loss) before income taxes	9,799	(10,140)	20,311	(14,425)
Deferred income tax expense (recovery)	2,873	(2,056)	5,718	(2,660)
Net income (loss) and comprehensive income (loss) for the period	\$ 6,926	\$ (8,084)	\$ 14,593	\$ (11,765)
Income (loss) per share (note 8)				
Basic	\$ 0.03	\$ (0.04)	\$ 0.06	\$ (0.05)
Diluted	\$ 0.03	\$ (0.04)	\$ 0.06	\$ (0.05)

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

Condensed Consolidated Interim Statements of Changes in Shareholders' Equity

Stated in thousands of dollars, except share amounts

(Unaudited)

	Number of common shares	Share capital	Contributed surplus	Warrants	Deficit	Total equity
Balance at December 31, 2015	221,032,888	\$ 1,256,630	\$ 40,391	\$ 3,522	\$ (488,402)	\$ 812,141
Net loss for the period	—	—	—	—	(11,765)	(11,765)
Transfer on exercise of RSAs and PSAs ⁽¹⁾	14,270	43	(43)	—	—	—
Stock-based compensation	—	—	5,345	—	—	5,345
Dividends	—	—	—	—	(12,434)	(12,434)
Balance at June 30, 2016	221,047,158	\$ 1,256,673	\$ 45,693	\$ 3,522	\$ (512,601)	\$ 793,287
Balance at December 31, 2016	225,754,665	\$ 1,274,195	\$ 41,110	\$ 3,522	\$ (539,650)	\$ 779,177
Net income for the period	—	—	—	—	14,593	14,593
Share issue costs, net of tax	—	(41)	—	—	—	(41)
Transfer on exercise of RSAs and PSAs ⁽¹⁾	11,728	54	(54)	—	—	—
Stock-based compensation	—	—	5,217	—	—	5,217
Dividends	—	—	—	—	(9,781)	(9,781)
Balance at June 30, 2017	225,766,393	\$ 1,274,208	\$ 46,273	\$ 3,522	\$ (534,838)	\$ 789,165

⁽¹⁾ RSA and PSA defined as restricted share and performance share awards

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

Condensed Consolidated Interim Statements of Cash Flows

Stated in thousands of dollars

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Cash provided by (used in)				
Operating				
Net income (loss)	\$ 6,926	\$ (8,084)	\$ 14,593	\$ (11,765)
Loss (gain) on disposal of petroleum and natural gas properties	34	—	34	(4,397)
Unrealized loss (gain) on financial contracts	(7,164)	9,025	(18,153)	1,495
Finance expense	3,387	2,242	6,182	4,638
Interest expense	(2,467)	(1,526)	(4,478)	(3,132)
Depletion and depreciation	22,475	19,271	43,200	40,864
Decommissioning expenditures	(366)	85	(942)	(317)
Stock-based compensation	40	2,280	(379)	2,979
Deferred income tax expense (recovery)	2,873	(2,056)	5,718	(2,660)
Change in non-cash working capital	(1,110)	(5,728)	(5,322)	(6,825)
Cash flow from operating activities	24,628	15,509	40,453	20,880
Financing				
Bank debt	34,296	6,539	55,261	(17,318)
Dividends paid	(4,985)	(5,525)	(9,405)	(13,815)
Share issue costs	—	—	(41)	—
Cash flow from (used in) financing activities	29,311	1,014	45,815	(31,133)
Investing				
Petroleum and natural gas properties	(15,064)	(16,810)	(49,105)	(29,683)
Disposition of petroleum and natural gas properties	276	—	545	43,178
Acquisitions	(35,992)	—	(35,992)	(2,037)
Change in non-cash working capital	(3,159)	287	(1,716)	(1,205)
Cash flow from (used in) investing activities	(53,939)	(16,523)	(86,268)	10,253
Change in cash	—	—	—	—
Cash, beginning of the period	—	—	—	—
Cash, end of the period	\$ —	\$ —	\$ —	\$ —

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Tabular amounts are in thousands of dollars, except share and per share data

(Unaudited)

1. REPORTING ENTITY

Surge Energy Inc.’s (the “Corporation” or “Surge”) business consists of the exploration, development and production of oil and gas from properties in western Canada. The Corporation is a dividend paying entity. The address of Surge’s registered office is 2100, 635-8th Avenue SW, Calgary, Alberta, Canada, T2P 3M3. The consolidated financial statements include the accounts of the Corporation, its wholly-owned subsidiaries and partnerships.

2. BASIS OF PREPARATION

Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with International Accounting Standard 34, “Interim Financial Reporting” and using the accounting policies outlined by the Corporation in its annual consolidated financial statements for the year ended December 31, 2016. These condensed consolidated interim financial statements do not include all of the information required for full annual financial statements. These condensed consolidated interim financial statements should be read in conjunction with the annual financial statements for the year ended December 31, 2016.

The condensed consolidated interim financial statements were authorized for issuance by the Board of Directors on August 2, 2017.

3. EXPLORATION AND EVALUATION ASSETS

Exploration and evaluation assets consist of the Corporation’s exploration projects which are pending the determination of proven or probable reserves. Additions represent the Corporation’s share of costs incurred on E&E assets during the period.

Exploration & Evaluation Assets

	Total
Balance at December 31, 2015	\$ 11,287
Impairment	(3,459)
Balance at December 31, 2016 and June 30, 2017	\$ 7,828

4. PETROLEUM AND NATURAL GAS PROPERTIES

Petroleum and Natural Gas Properties

	Total
Balance at December 31, 2015	\$ 1,899,671
Acquisitions	20,465
Dispositions	(87,686)
Additions	73,962
Assets under finance lease	6,161
Change in decommissioning obligations	(6,766)
Capitalized stock-based compensation	8,297
Balance at December 31, 2016	\$ 1,914,104
Acquisitions	44,455
Dispositions	(1,897)
Additions	49,105
Change in decommissioning obligations	26,311
Capitalized stock-based compensation	3,254
Balance at June 30, 2017	\$ 2,035,332

	Total
Accumulated depletion and depreciation	
Balance at December 31, 2015	\$ (829,360)
Depletion and depreciation expense	(83,872)
Dispositions	40,279
Balance at December 31, 2016	\$ (872,953)
Depletion and depreciation expense	(43,200)
Dispositions	777
Balance at June 30, 2017	\$ (915,376)

	Total
Carrying amounts	
At December 31, 2016	\$ 1,041,151
At June 30, 2017	\$ 1,119,956

The calculation of depletion and depreciation expense for the period ended June 30, 2017 included an estimated \$417.1 million (December 31, 2016 - \$435.8 million) for future development costs associated with proved plus probable reserves and deducted \$115.0 million (December 31, 2016 - \$103.8 million) for the estimated salvage value of production equipment and facilities.

During the period ended June 30, 2017 the Corporation acquired certain petroleum and natural gas properties in Southeast Alberta for cash consideration of \$36.0 million. The Corporation also assumed decommissioning obligations of \$8.5 million.

During the period ended June 30, 2017 the Corporation disposed of certain non-core assets and facilities in Central Alberta for cash proceeds of \$0.5 million. The assets had a carrying value of \$1.1 million at the time of disposition and an associated decommissioning liability of \$0.5 million, resulting in a loss on disposal of \$0.1 million.

During the period ended June 30, 2016 the Corporation disposed of certain non-core assets and facilities in Northern Alberta for cash proceeds of \$43.2 million. The assets had a carrying value of \$46.9 million at the time of disposition and an associated decommissioning liability of \$8.1 million, resulting in a gain on disposal of \$4.4 million.

During the period ended June 30, 2016 the Corporation acquired certain petroleum and natural gas properties in Northern Alberta for cash consideration of \$2.0 million.

5. RISK MANAGEMENT

As a means of managing commodity price volatility, the Corporation enters into various derivative financial instrument agreements and physical contracts. The fair value of forward contracts and swaps is determined by discounting the difference between the contracted prices and published forward price curves as at the statement of financial position date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate (based on published government rates and considering counter-party credit risk). 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. Surge's financial derivative contracts are classified as level two in the fair value hierarchy.

At June 30, 2017, the following risk management contracts were outstanding with an asset fair market value of \$5.1 million and a liability fair market value of \$nil (December 31, 2016 – asset of \$nil and liability of \$13.1 million):

WTI Oil Hedges

Type	Term	bbl/d	Currency	Floor (per bbl)	Ceiling (per bbl)	Swap Price (per bbl)
WTI	2H 2017 ⁽¹⁾	1,500	CAD	\$60.00	\$78.33	—
WTI	Apr-Dec 2017	1,250	USD	—	—	\$55.18
WTI	2H 2017	1,000	USD	\$47.00	—	—
WTI	2H 2017	800	USD	—	\$59.38	—
WTI	1H 2018	1,000	USD	\$47.50	—	—
WTI	2018	750	USD	\$45.00	\$58.00	—
WTI	2018	500	CAD	\$60.00	\$68.91	—
WTI	2018 ⁽²⁾	500	USD	—	\$57.45	—
WTI	1H 2018	600	USD	—	\$63.19	—
WTI	1H 2018	1,500	USD	\$50.00	\$60.87	—
WTI	2H 2018	1,500	USD	\$50.00	—	—

Oil Differential Hedges

Type	Term	bbl/d	Currency	Floor (per bbl)	Ceiling (per bbl)	Swap Price (per bbl)
WCS Swap	2017	500	USD	—	—	US\$WTI less \$22.00
WCS Swap	Apr-Dec 2017	500	USD	—	—	US\$WTI less \$14.50
WCS Collar	1H 2018	1,500	USD	US\$WTI less \$13.00	US\$WTI less \$18.00	—
MSW (EDM) Swap	2017	2,000	USD	—	—	US\$WTI less \$3.18

Natural Gas Hedges

Type	Term	mcf/d	Currency	Swap Price (per mcf)
Chicago Swap ⁽³⁾	Jan-Oct 2017	10,000	CAD	\$3.63

CAD/USD FX Hedges

Type	Term	Monthly Notional Amount (US\$)	Total Notional Amount (US\$)	Swap Rate (CAD\$ per USD\$)
Avg Rate Forward	Apr-Dec 2017	\$2,000,000	\$18,000,000	\$1.33
Avg Rate Forward	2018	\$2,000,000	\$24,000,000	\$1.30

⁽¹⁾ If market prices settle at or below CAD\$50 WTI, the Company will receive a locked-in cash settlement of the market price plus CAD\$10 per bbl on 1,500 bbl/d in 2H 2017.

⁽²⁾ Surge purchased a call at USD\$57.45/bbl, allowing the Company the return to participation in rising crude oil prices above US\$57 WTI.

⁽³⁾ Surge entered into a Chicago-priced swap as the Company's firm transport contracts settle against the Chicago index.

The following table summarizes the sensitivity of the fair value of the Corporation’s market risk management positions to fluctuations in natural gas prices, crude oil prices, and foreign exchange. All such fluctuations were evaluated independently, with all other variables held constant. In assessing the potential impact of these fluctuations, the Corporation believes that the volatilities presented below are reasonable measures. Fluctuations in crude oil and natural gas prices would have had the following impact on the net income (loss):

Net earnings impact for the period ended June 30, 2017		
	Price Increase	Price Decrease
Crude Oil - Change of +/- \$1.00	(2,835)	2,835
Natural Gas - Change of +/- \$0.10	(92)	92
Foreign Exchange - Change of +/- \$0.01	(30)	30

6. BANK DEBT

As at June 30, 2017, the Corporation had an extendible, revolving term credit facility at \$285 million with a syndicate of Canadian banks. The facility is available on a revolving basis until May 28, 2018. On May 28, 2018, at the Corporation's discretion, the facility is available on a non-revolving basis for a one-year period, at the end of which time the facility would be due and payable. Alternatively, the facilities may be extended for a further 364-day period at the request of the Corporation and subject to the approval of the syndicate. As the available lending limits of the facilities are based on the syndicate’s interpretation of the Corporation’s reserves and future commodity prices, there can be no assurance that the amount of the available facilities will not decrease at the next scheduled review. Interest rates vary depending on the ratio of net debt to cash flow. The facility had an effective interest rate of prime plus 1.90 percent as at June 30, 2017 (December 31, 2016 – prime plus 1.75 percent).

The facility is secured by a general assignment of book debts, debentures of \$1.5 billion with a floating charge over all assets of the Corporation with a negative pledge and undertaking to provide fixed charges on the major producing petroleum and natural gas properties at the request of the bank. Under the terms of the agreement, the Corporation is required to meet certain financial and engineering reporting requirements.

7. DECOMMISSIONING OBLIGATIONS

The Corporation's decommissioning obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Corporation estimates the total inflated and undiscounted amount of cash flows required to settle its decommissioning obligations is approximately \$341.4 million (December 31, 2016 – \$300.1 million). These payments are expected to be made over the next 50 years with the majority of costs to be incurred between 2022 and 2066. A risk free rate of 2.13 percent (December 31, 2016 – 2.31 percent) and an inflation rate of 1.50 percent (December 31, 2016 – 1.50 percent) was used to calculate the fair value of the decommissioning obligations.

A reconciliation of the decommissioning obligations is provided below:

	June 30, 2017	December 31, 2016
Balance, beginning of period	\$ 120,025	\$ 129,827
Liabilities related to acquisitions (note 4)	8,463	3,507
Liabilities related to dispositions (note 4)	(541)	(8,076)
Change in estimate	25,370	(8,943)
Liabilities incurred	941	2,177
Accretion expense	1,632	2,804
Decommissioning expenditures	(942)	(1,271)
Balance, end of period	\$ 154,948	\$ 120,025

The decommissioning obligations acquired in the Southeast Alberta acquisition (note 4) were initially recognized using a fair value discount rate. They were subsequently revalued using the risk-free rate noted above resulting in a change in estimate with the offset to petroleum and natural gas properties.

8. SHARE CAPITAL

(a) Authorized

Unlimited number of voting common shares.

Unlimited number of preferred shares, issuable in series.

(b) Warrants

The Corporation has 1,400,560 warrants exercisable at a price of \$4.46. The exercise price is downward adjusted for dividends paid. The warrants become exercisable based on certain time based and performance based conditions. Specifically with respect to time they are exercisable up to one third on each anniversary from the date of the grant, and with respect to performance up to one half when the market price of the Corporation reaches \$6.30 and the other half when it reaches \$8.40. The warrants expire in June 2018. As at June 30, 2017, 1,400,560 warrants were exercisable.

(c) Stock Appreciation Rights

The Corporation had 2.0 million SAR's outstanding at June 30, 2017. The SARs vest up to one third on each anniversary from the date of grant and expire in June 2018. The exercise price is downward adjusted for dividends paid. As such the exercise price at June 30, 2017 is \$2.07 (December 31, 2016 - \$2.11) and 2.0 million SARs were vested and exercisable. The SARs when exercised are to be cash settled based on the difference between the Corporation's common share price on the date of exercise and the adjusted exercise price. The Corporation has valued the SARs using a Black Scholes valuation model and will continue to revalue at each reporting period until ultimate cash settlement. During the six month period ended June 30, 2017, the Corporation realized a decrease to the liability within accounts payable and an offsetting decrease to stock-based compensation of \$2.3 million (2016 - \$1.0 million increase). There is \$0.7 million included in accounts payable at June 30, 2017 (December 31, 2016 - \$3.1 million).

(d) Restricted and Performance Share Award Incentive Plan

The Corporation has a Stock Incentive Plan which authorizes the Board of Directors to grant restricted share awards ("RSAs") and performance share awards ("PSAs") to directors, officers, employees and certain consultants of Surge.

Subject to the terms and conditions of the plan, each RSA entitles the holder to an award value to be typically paid as to one-third on each of the first, second and third anniversaries from the date of grant. Each PSA entitles the holder to an award value to be typically paid on the third anniversary of the date of grant. For the purpose of calculating share-based compensation, the fair value of each award is determined at the grant date using the closing price of the common shares. An estimated forfeiture rate of 15% (2016 - 15%) was used to value all awards granted for the period ended June 30, 2017. The weighted average fair value of awards granted for the six month period ended June 30, 2017 is \$3.37 (2016 - \$1.93) per PSA granted and \$3.30 (2016 - \$2.18) per RSA. In the case of PSAs, the award value is adjusted for a payout multiplier which can range from 0.0 to 2.0 and is dependent on the performance of the Corporation relative to pre-defined corporate performance measures for a particular period. On the vesting dates, the Corporation has the option of settling the award value in cash or common shares of the Corporation. For purposes of stock-based compensation a payout multiple of 1.0 was assumed for the PSAs granted during the period.

The total number of RSA and PSA units granted cannot exceed 4.5 percent of the issued and outstanding shares of the Corporation.

The number of restricted and performance share awards outstanding are as follows:

	Number of restricted share awards	Number of performance share awards
Balance at January 1, 2017	3,602,528	4,809,052
Granted	108,109	100,000
Reinvested ⁽¹⁾	58,793	79,111
Exercised	(11,728)	—
Forfeited	(97,997)	(22,292)
Balance at June 30, 2017	3,659,705	4,965,871

⁽¹⁾ Per the terms of the plan, cash dividends paid by the Corporation are reinvested to purchase incremental awards.

(e) Stock-based compensation

A reconciliation of the stock-based compensation expense is provided below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Stock-based compensation on options	\$ —	\$ 2	\$ —	\$ 5
Stock-based compensation on SARs	(940)	1,080	(2,340)	966
Stock-based compensation on PSAs and RSAs ⁽¹⁾	3,091	4,021	6,139	6,648
Capitalized stock-based compensation	(1,656)	(1,949)	(3,254)	(3,332)
Total stock-based compensation expense	\$ 495	\$ 3,154	\$ 545	\$ 4,287

⁽¹⁾ Included in stock-based compensation for the six month period ended June 30, 2017 is cash expenditures of \$0.9 million paid to acquire shares offered to employees and service providers (2016 - \$1.3 million).

(f) Per share amounts

The following table summarizes the shares used in calculating earnings (loss) per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Weighted average number of shares - basic	225,766,393	221,046,752	225,765,162	221,044,610
Effect of dilutive instruments	3,790,055	—	3,598,397	—
Weighted average number of shares - diluted	229,556,448	221,046,752	229,363,559	221,044,610

In computing diluted per share amounts at June 30, 2017, 26,000 options (June 30, 2016 – 89,200), 1,400,560 warrants (June 30, 2016 – 1,400,560), 6,000 RSAs (June 30, 2016 – 3,356,779) and 101,422 PSAs (June 30, 2016 – 3,544,610) were excluded from the calculation as their effect was anti-dilutive.

(g) Dividends

The Board of Directors declared for the months of January through June 2017 cumulative dividends of \$0.043324 per share (January - June 2016 - \$0.05625 per share). Dividends of \$0.007917 per share are declared and outstanding at June 30, 2017 and were paid in July 2017. The dividend for July 2017 has been declared at \$0.007917 per share.

9. COMMITMENTS

Future minimum payments relating to operating lease and firm transport commitments at June 30, 2017 are as follows:

(\$000s)	
2017	\$ 5,951
2018	8,525
2019	8,057
2020	7,633
2021	6,004
2022+	8,951
Total	\$ 45,121