

**TERRACE ENERGY CORP.**  
(the “Company”, “Corporation” or “Terrace”)  
**MANAGEMENT’S DISCUSSION AND ANALYSIS**  
**OF THE COMPANY’S FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015**

**Introduction**

The following management discussion and analysis of the financial condition and results of operations (“MD&A”) of the Company has been prepared by management, in accordance with the requirements of National Instrument 51-102 as of June 29, 2016 and should be read in conjunction with the Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015 and the related notes contained therein, which have been prepared under International Financial Reporting Standards (“IFRS”). The information contained herein is not a substitute for detailed investigation or analysis on any particular issue and is not intended to be a comprehensive review of all matters and developments concerning the Company. Additional information relevant to the Company’s activities including the appraisal report on proved and probable reserves can be found on SEDAR at [www.sedar.com](http://www.sedar.com) and the Company’s website at [www.terraceenergy.net](http://www.terraceenergy.net).

All financial information in this report has been prepared in accordance with IFRS and all monetary amounts referred to herein, are in United States dollars, unless otherwise stated.

**Caution Regarding Use of Barrels of Oil Equivalent (BOEs)**

BOEs/boes may be misleading, particularly if used in isolation. A BOE conversion ratio of six (6) Mcf to one (1) bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. As the value ratio between natural gas and crude oil based on the current prices of natural gas and crude oil is significantly different from the energy equivalency of 6:1, utilizing a conversion on a 6:1 basis may be misleading as an indication of value.

**Cautionary Statement Regarding Forward Looking Statements**

This discussion and analysis contains “forward-looking information” and “forward-looking statements” within the meaning of applicable Canadian securities laws and the United States Private Securities Litigation Reform Act of 1995, respectively (together, “**forward-looking information**”), concerning the Corporation’s plans for its projects, production, capital, operating and cash flow estimates, anticipated financial performance, business prospects and strategies and other general matters. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those included in the forward-looking information. The use of words such as “intend”, “anticipate”, “continue”, “estimate”, “expect”, “may”, “will”, “project”, “should”, “believe” and similar expressions are intended to identify forward-looking information. Such statements are included, among other places, in this discussion and analysis under the headings “*Executive Overview of Operations*”, “*Outlook*”, “*Exploration and Development Assets*”, “*Financial Condition, Liquidity and Capital Resources*” and “*Risk Factors*”. Statements relating to “reserves” are also forward-looking information, as they involve the implied assessment, based on certain estimates and assumptions, including that the reserves described can be profitably produced in the future. These statements and information are only predictions based on current information and knowledge. Actual future events or results may differ materially. In addition, this discussion and analysis may contain forward-looking information attributed to third party industry sources. Undue reliance should not be placed on such forward-looking information, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By its nature, forward-looking information involves numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking information will not be realized. In addition, the exploration and development of oil and gas properties involves certain significant risks, not within the control of management, which can adversely impact the Company’s plans and expectations (see “Risk Factors”).

In particular, this discussion and analysis contains forward-looking information pertaining to the following:

- expectations regarding the Corporation and/or its co-venturers' ability to satisfy capital expenditure requirements to maintain the Corporation's projects in good standing;
- plans for selling project interests and/or sharing expenditure requirements with new joint venture partners;
- performance characteristics of the Corporation's producing properties;
- crude natural gas, natural gas liquids and oil production estimates and targets;
- the size of the Corporation's natural gas, natural gas liquids and oil reserves;
- planned capital expenditure programs and estimates;
- timing of commencement of fracture stimulations and drilling of additional wells and the Corporation's expectations as to the outcomes of the foregoing;
- hypotheses regarding the geology of the basins in which the Corporation has operations and is conducting exploratory work;
- expectations regarding the potential number of additional drilling locations on the Corporation's projects;
- projections of market prices and costs;
- expectations regarding future supply and demand for oil and natural gas;
- expectations regarding the ability to attract and retain appropriately qualified employees and consultants;
- expectations regarding the ability to raise capital and to add to reserves through acquisitions and development; and
- anticipated treatment under governmental regulatory regimes and tax laws.

This forward-looking information is based on a number of assumptions, including, but not limited to, the following:

- assumptions set out herein and in the Corporation's most recently filed Form 51-101F1 oil and gas report;
- stability in the credit markets and continued willingness of lenders to lend capital to issuers such as the Corporation;
- continuing availability of funds for capital expenditures through internally generated cash and/or equity raises or debt raises;
- that the Corporation will continue to satisfy its covenants and meet its obligations under the terms of its outstanding debt;
- stability of the political and fiscal regimes in the countries in which the Corporation has operations;
- ability of the Corporation to hold the mineral leases and projects in which it has interests and to find suitable industry partners to assume or share capital expenditure requirements necessary to keep various of the Corporation's projects in good standing, if and as needed;
- stable future costs;
- availability of equipment and personnel when required for operations;
- future strong demand for oil and natural gas;
- that the Corporation will not experience unforeseen delays, unexpected geological, environmental or other natural occurrences, equipment failures, permitting delays or delays in procurement of required equipment or personnel;
- that the Corporation will not experience labour or contract disputes;
- that the Corporation's financial condition and development plans and those of its co-venturers will not substantially change;
- the assumptions underlying estimates of reserves;
- that indications of early results are reasonably accurate predictors of the prospectiveness of the hydrocarbon bearing strata;
- that environmental and other regulations affecting the Corporation will not substantially change, and that required regulatory approvals will be available when required;

- that expected production from future wells can be achieved as modeled and that declines will match the modeling;
- that rates of return as modeled can be achieved;
- that reserve recoveries are consistent with management's expectations;
- that additional wells are actually drilled and completed;
- expectations and assumptions regarding future growth, results of operations, production, future capital and other expenditures (including the amount, nature and sources of funding thereof);
- plans for and results of drilling activity; and
- assumptions regarding business prospects and opportunities.

Actual results could differ materially from those anticipated in forward-looking information as a result of the risks and uncertainties set forth below and elsewhere in this discussion and analysis:

- the risk that the Corporation is unable to access required capital or conclude agreements with new industry partners to fund or assist in funding capital expenditure requirements to maintain projects in good standing and to discharge outstanding debt as it becomes due;
- continued volatility in, and depressed market prices for, oil and natural gas;
- risks inherent in oil and gas operations;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel;
- incorrect assessments of the value of acquisitions;
- geological, technical, drilling and processing problems;
- uncertainties associated with the utilization of hydraulic fracturing in relation to the Corporation's existing and/or future properties;
- fluctuations in foreign exchange or interest rates and stock market volatility;
- rising costs of labour and equipment;
- inherent uncertainties involved in the legal dispute resolution process;
- changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry;
- tightening of the credit markets, global economic uncertainty, and counterparty risk;
- equipment failures, permitting delays, delays in procurement of required equipment or personnel, and labour or contract disputes;
- changes in the Corporation's financial condition and development plans or those of its co-venturers;
- risks relating to disagreements or disputes with joint venture partners, including any failure of a joint venture partner to fund its obligations;
- risks and uncertainties associated with securing necessary regulatory approvals, including the risk that the Corporation or its subsidiaries is not able for any reason to obtain and provide the information necessary to secure required approvals or that required regulatory approvals are otherwise not available when required;
- risks and uncertainties associated with potential changes in environmental or other regulations, permitting processes or taxation;
- the risk that the Corporation will be unable to successfully renegotiate the terms of contracts as may be necessary in order for the Corporation to maintain its interest in its projects;
- the risk that unexpected geological results are encountered, completion techniques require further optimization or production rates do not match the Corporation's assumptions; and
- other factors discussed under "*Risk Factors*" below.

Although the Corporation has attempted to identify important factors that could cause actual actions, events or results to differ materially from those described in forward-looking information, there may be other factors that cause actions, events or results not to be as anticipated, estimated or intended. There can be no assurance that

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forward-looking information will prove to be accurate, as actual results and future events could differ materially from those anticipated in such information. The reader is cautioned not to place undue reliance on forward-looking information. The forward-looking information contained herein is presented for the purpose of assisting investors in understanding the Corporation's expected financial and operating performance and the Corporation's plans and objectives in making an investment decision and may not be appropriate for other purposes. All forward-looking information is expressly qualified in its entirety by this cautionary statement. The Corporation disclaims any obligation to update forward-looking information to reflect events or circumstances after the date of such statements, or to reflect the occurrence of anticipated or unanticipated events, except as required by law.

**Cautionary Note to United States Investors**

This discussion and analysis and the Company's consolidated financial statements are prepared and presented in accordance with the rules and regulations that govern Canadian reporting issuers, as required by the TSX Venture Exchange (the "Exchange") and applicable securities laws in Canada. The Company does not report to the United States Securities and Exchange Commission, and, in its public disclosure, it may use terms which are not permitted terminology in the United States. In addition, United States investors are cautioned that the Company's consolidated financial statements do not conform with, nor are they reconciled to, accounting principles generally accepted in the United States.

**Company Overview**

Terrace Energy Corp. (the "Company" or "Terrace") was incorporated on July 6, 2006 under the Business Corporations Act (British Columbia) and previously named Terrace Resources Inc.

The Company is in the business of acquiring, exploring and developing onshore oil and gas properties in the United States. The Company has a limited history of revenues and operating cash flows. The continuing operations of the Company are therefore dependent upon its future profitable operations and its ability to raise additional capital as required, neither of which is assured. The Company's head office is located at Suite 270 – 666 Burrard Street, Vancouver, B.C., V6C 2X8. It's registered and records office is located at 10<sup>th</sup> Floor, 595 Howe Street, Vancouver, British Columbia V6C 2T5. The Company also maintains its principal office at Suite 407, 202 Travis Street, Houston, Texas 77002 where all its operating activities are managed.

The Company's common shares trade on the Exchange under the symbol "TZR", on the OTCQX in the United States under "TCRRF" and on the Frankfurt Exchange under "2TR".

The following table lists the Company's principal operating subsidiaries, their jurisdiction of incorporation and its percentage ownership of their voting securities as of the date of this report:

Name of subsidiary	Place of Incorporation	Percentage ownership
Terrace US Holdings LLC	USA	100%
Terrace Operating, LLC	USA	100%
Terrace Cutlass, LLC	USA	100%
TEC Operating, LLC	USA	100%
Terrace BWP, LLC	USA	100%
Terrace Investment Holdings Inc.	USA	100%
TEC Olmos, LLC	USA	100%

See "Exploration and Evaluation Assets" for the Company's interest in BlackBrush Terrace LP.

### **Executive Overview of Operations**

Fiscal 2016 proved to be one of the most challenging years which the oil & gas industry has faced this century. The unprecedented drop in commodity prices, while showing some signs of “bottoming out”, is not yet showing a clear trend towards long term price increases. Consequently, the Company has continued to maintain its defensive posture to preserve core assets and maintain optionality to continue to weather the storm until conditions improve. The Company has been and will continue to focus all of its efforts on maximizing its leasehold and drilling location inventory while minimizing the cost of maintaining that inventory. The Company has also implemented a program to materially reduce operating costs while maintaining a long-term relationship with its key human resources and stakeholders. These strategies are focused on ensuring our continued viability during this difficult commodity price environment, while ensuring that we maintain a core foundation from which to rebuild as conditions improve.

During the prior year the Company completed the minimum required development activities at our Olmos Tight Sandstone Development Project (the “STS Olmos Project”) and our Maverick County Project to fulfill its 2015 obligations necessary to preserve its leasehold position and has suspended further operations until market conditions improve and / or lease maintenance operations are required and are deemed prudent. The Company and its partner also successfully reached agreement with our mineral interest owner to defer the leasehold obligations for calendar 2016 at the STS Olmos Project through a small deferral payment made in the second quarter of 2016. This deferral agreement also contains a further deferral option for calendar 2017 in the event that commodity prices continue to languish. Those deferral payments will be funded through the available cash in the Terrace STS, LLC subsidiary.

Due to the continued depression in commodity prices, the Company’s wholly-owned subsidiary, Terrace STS, LLC (“STS”) has been unable to cure certain events of default related to its Credit Agreement with its lender. Subsequent to quarter-end, in May 2016, the Company and the lender have entered into an agreement wherein the lender converted its senior secured debt into ninety five percent (95%) of the membership units of STS. The Company continues to own the remaining five percent (5%) of the membership units of STS. Additionally, the Company, through its wholly-owned subsidiary Terrace US Holdings, LLC (“Holdings”) will operate STS through a management contract providing for reasonable overhead fees as well as certain incentives wherein Holdings may earn additional interest in STS after certain financial hurdles are met. STS owns the developed leases of the STS Olmos Project. The transaction will result in the Company losing control of STS and will deconsolidate STS following the transaction.

The STS Project provides consistent, repeatable results from a technical perspective. Therefore, the Company continues to look for cost effective opportunities to continue to expand its acreage position with strategic leasehold acquisitions that have no near term development capital requirements. This strategy will allow the Company to position itself as a dominant Olmos Sandstone development company when the commodity market strengthens sufficiently to allow for a resumption of operations. In July, 2015, the Company entered into an agreement with its partner to establish an area of mutual interest (the “AMI”) covering more than 200,000 acres surrounding its existing STS Olmos Project acreage. This agreement ensures that Terrace and its partner’s interests are aligned and will work together as acreage acquisition opportunities are identified and evaluated. During the third quarter, the Company and its partner acquired approximately 8,000 gross acres (4,000 net to the Company) immediately adjacent to the existing STS development acreage. This acreage is under a three-year, primary term lease which will allow the Company to defer any capital drilling commitments until as late as calendar 2018. This new acreage and the AMI are not part of the transaction with the STS lender described above and remain as assets of the Company.

The Company and its partner were also successful in renegotiating the schedule under which the long-term obligations of its BlackBrush Terrace LP (“BTLP”) Partnership under its farmout agreement with Shell are

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required. Under the Fourth Amendment to the Farmout Agreement, negotiated during the third quarter of 2015, the BTLF has deferred all further material capital expenditure obligations until late calendar year 2017.

The Company has also taken steps to reduce or eliminate corporate costs while continuing to maintain viability for the future. Management and staff have voluntarily modified their employment contracts to reduce salaries and eliminate key long-term employment benefits. The Company has established an active third-party consulting practice to cover salaries for the technical personnel including both technical Vice Presidents and the COO. Other management and support salaries have been significantly reduced and are fully covered by recently executed third-party management services contracts. Other elements of corporate overhead have been significantly reduced or eliminated, particularly in the areas of office services, communications and investor relations.

Also subsequent to quarter-end, the Company has entered into a Plan of Arrangement wherein it has exchanged its previous 8% unsecured notes maturing in April 2018 ("Old Notes") for new notes maturing in April 2021 which will not be interest bearing ("New Notes"). The Old Notes, representing \$38,590,000 CAD, are exchanged for an equivalent number of New Notes representing the same value. The unpaid interest outstanding at the time of the exchange was forgiven when the exchange was completed. This note exchange is critical to the Company's overall strategy in that it will allow the Company to preserve critical liquidity while continuing to pursue strategic alternatives as discussed below.

The following unaudited consolidated pro-forma financial position as if the above STS and note exchange transactions had occurred as at April 30, 2016:

<i>As at April 30,</i>	<b>2016</b>
<b>Assets</b>	
Current assets	\$ 1,888,860
Non-current assets	10,415,030
Total assets	<u>\$ 12,303,890</u>
<b>Liabilities and Shareholders' Deficit</b>	
Current liabilities	\$ 705,812
Non-current liabilities <sup>(1)</sup>	29,085,172
Total liabilities	29,790,984
Shareholders' deficit <sup>(1)</sup>	<u>(17,487,094)</u>
Total liabilities shareholders' deficit	<u>\$ 12,303,890</u>

- <sup>(1)</sup> The impact of the extinguishment of debt of the Existing Notes and the allocation between debt and equity of the New Notes has not been reflected, as it has not been determined yet.

## **Outlook**

The Company continues to believe that this current commodity price environment is unsustainable. This price environment places the viability of the entire energy business, and by extension, the world-wide economy in jeopardy. Consequently, the Company's strategy is based on its view that recovery will occur at some point in the future and the core assets currently held by the Company are likely to increase in value over their existing market value. Because the period of the expected recovery remains unclear, the Company is maintaining its defensive posture in order to preserve stakeholder value by minimizing costs and near-term obligations while building and maintaining an attractive inventory of future drilling locations with minimal near-term capital commitments, in order to maintain both long-term opportunity and near-term liquidity. The key elements of this defensive strategy include (i) continuing to work with land owners and partners to defer capital expenditures on our existing leases without diminishing the assets; (ii) securing third-party consulting and management contracts to effectively eliminate salary burdens while maintaining long-term relationships with our key employees; and (iii) managing agreements with creditors to eliminate the pressure to liquidate assets in sub-optimal market conditions.

In addition to these defensive strategies to preserve assets and liquidity, the Company, together with its corporate advisors, is continuing to aggressively seek out opportunities for oil and gas producing property acquisitions, and exploration and development projects. The Company continues to evaluate different financial options, including, but not limited, raising additional capital, joint venturing the exploration and development of its assets, the sale of certain assets and the combination of the Company with a strategic partner. Although market conditions have made this process very challenging, the Company is involved in ongoing discussions with multiple interested parties.

### **Exploration and Development Assets**

The following is a brief description of the principal assets owned by the Company during the quarter:

#### *Maverick County Project (Investment in BlackBrush Terrace LP)*

The Company and its partner, BlackBrush Oil & Gas, LP ("**BlackBrush**") organized a special purpose limited partnership, the BlackBrush Terrace LP (the "**BTLP**"), to acquire a 50% operated working interest (the "**WI**") in certain oil and gas leases covering approximately 147,000 gross mineral acres in Maverick County Texas, USA (the "**Maverick County Project**") from SWEPI LP ("**Shell Oil**"). The acreage to be acquired includes potential reserves in the Eagle Ford Shale, Buda Limestone and several other intervals of Cretaceous age formations including the newly emerging Pearsall Shale Trend which have been proven productive on a regional basis. The agreement allows BTLP to secure the WI through a combination of cash payments, which have been made, and drilling obligations. The material terms of the farmout agreement between the BTLP and Shell Oil are as follows:

1. the BTLP has made an up-front cash payment of \$13 million;
2. the BTLP has the option, but not the obligation, to earn the assignment of the WI in all of the leases by spending an aggregate of \$104 million (\$52 million net to Terrace), including \$52 million (\$26 million net to Terrace) representing Shell Oil's share of costs (the "**Carry Payment**") on certain qualified expenditures as development of the property progresses over time;
3. upon completion of each well drilled under this agreement, the BTLP may request an assignment of 50% of Shell Oil's interest in such well;
4. upon making the Carry Payment in full, the BTLP may request an assignment of 50% of Shell Oil's interest in all of the subject leases and shall have the option, but not the obligation, to participate in a 50% working interest in each subsequent well by paying its proportionate share of all development costs for such well unless Shell Oil elects to convert its working interest in a producing formation into a net profits interest; and
5. Shell Oil has the right, but not the obligation, to assume operatorship of any formation in which production has been established at any time within two years after the later of (i) the Carry Payment being made in full and subsequent assignment of 50% of Shell Oil's interest in the subject leases or (ii) establishment of commercial production from a given formation.

During 2013, the BTLP successfully tested the Eagle Ford formation through the re-entry and completion of the SWEPI Chittim #F-1H, which was previously drilled and shut in by Shell Oil in 2011 and the drilling and completion of a second well to test the Eagle Ford and Buda Limestone Formations. To date, these well have produced in excess of 50,000 BOE (gross) from the Eagle Ford Shale and are continuing to produce. The BTLP also drilled and evaluated an obligatory Pearsall Shale evaluation well, the Chittim #1H which showed numerous positive indications of hydrocarbons, but was not able to be completed as a commercial success.



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During 2014, the BTLP also drilled four evaluation wells including two horizontal wells to evaluate the Buda Limestone potential on the southern portion of the ranch and two vertical stratigraphic tests to evaluate several formations from Austin Chalk through Georgetown in a portion of the ranch penetrated by a large serpentine plug (volcanic feature). Most notably, these wells confirm the presence of the Eagle Ford Shale in three separate areas of the project covering at least 50,000 gross acres.

During the prior year, the BTLP drilled a new Eagle Ford Shale well, the Chittim #10H, which was successfully completed during July 2015. The well has subsequently been placed into permanent production facilities. As of April 30, 2016, the well has produced approximately 44,411 BOE. The partnership also performed a minimal completion on one of the previously drilled Buda Limestone wells, the Chittim #4H to evaluate the production potential of the Buda Limestone in that area of the ranch. Prior to these activities, the Company sought and came to an agreement with its partner wherein to preserve capital, the Company would not contribute its share of costs to drill and complete these additional wells. As a result, the Company's 50% ownership interest in the BTLP partnership will be reduced from 50% to approximately 44%. In accordance with the provisions of the partnership agreement, the Company will not be entitled to any revenue and expense allocations or distribution of revenue proceeds from the Chittim #10H well.

In addition to the previously funded \$13 million up-front payment, as of April 30, 2016, the BTLP partnership has spent approximately \$40 million towards its drilling obligation to Shell. During the prior year, the BTLP was also successful in renegotiating the schedule under which its long-term obligations under its farmout agreement are required. Under the Fourth Amendment to the Farmout Agreement, executed during the fourth quarter of 2015, the BTLP has deferred all further material capital expenditure obligations until calendar year 2017, at which point, the BTLP will be obligated to resume expenditures of \$25 million in 2017 and the remaining balance of the Carry Payment and drilling obligation (approximately \$38 million) in 2018. The BTLP also retains the option to pay approximately \$2 million in liquidated damages at the end of 2017 if it chooses to further defer drilling operations at that point. If the Carry Payment is not satisfied in full by the end of 2018, then the partnership will be required to pay \$4 million in liquidated damages and the Farmout Agreement will be terminated.

During the quarter ended April 30, 2016, the Company's recognized share of the BTLP's net loss was \$38,035. The Company's share of production from the partnership for the quarter ended April 30, 2016 was 276 BOE.

The Company has a carrying value in the partnership of \$7,453,487 at April 30, 2016, which includes \$24,436,840 in advances representing the Company's share of costs to organize, acquire and fund certain agreed-upon exploration and evaluation activities to date plus the Company's share of the cumulative net losses of the partnership of \$16,983,353 of which approximately \$16,020,248 of the loss was attributable to the impairment charge described above and an impairment taken on the partnership's two Eagle Ford evaluations wells in prior years.

*Olmos Tight Sandstone Development Project*

In November 2011, the Company, through a wholly-owned subsidiary, acquired varying working and net revenue interests, which average approximately 26.88% and 20.16%, respectively, in approximately 14,400 gross mineral acres (3,875 net mineral acres) in LaSalle and McMullen Counties, Texas (the "**Original STS Olmos Leases**") and an evaluation well.

Through April 30, 2016, the Company has participated in the reentry and horizontal extension of the evaluation well and the drilling of twenty additional development wells on the Original STS Olmos Leases, all of which were drilled horizontally with lateral lengths averaging approximately 4,500 feet. Seventeen of these wells were successfully completed in the Olmos tight sandstone formation using multi-hydraulic fracturing techniques. The remaining three wells are currently awaiting completion.

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In January 2014, the Company, through a wholly-owned subsidiary, acquired a 33.34% working interest and a 24.59% net revenue interest in approximately 199 gross mineral acres “the **Quintanilla Lease**” in the Northwest AWP Area in McMullen County, Texas. On August 3, 2014 the Company spud the Quintanilla OL 1-H well, which was successfully completed during October 2014 and is currently producing at rates consistent with the performance of the STS Olmos wells.

As of April 30, 2016, the Company's subsidiary, Terrace STS, LLC, was not in compliance with certain covenants under the credit agreement with its lender. The loan, was secured by the assets of Terrace STS, LLC, and was non-recourse to Terrace Energy Corp. The Terrace STS, LLC oil & gas assets consist of the ~3,900 net acre Original STS Olmos Leases, the Quintanilla Lease and the associated producing wells and infrastructure. During May 2016, the Company entered into a transaction whereby the Company relinquished 95% of the equity of the Terrace STS, LLC to the lender who contributed the outstanding debt which is now deemed paid. In addition to the 5% ownership interest retained in Terrace STS, the Company has the right to receive distributions in excess of its ownership interest once certain return thresholds are achieved by the holder of the 95% equity interest in Terrace STS, LLC.

During October 2015, pursuant to an Area of Mutual Interest agreement with our partner, the Company, through a wholly-owned subsidiary, paid \$1.4 million to acquire a 50% non-operated working interest in approximately 8,000 gross acres (4,000 net acres) immediately adjacent to our Original STS Olmos Leases, depth limited to the Olmos Sandstone and shallower formations. This acreage is under a three-year, primary term lease, after which the acreage may continue to be held by a continuous drilling commitment of three completions per year thereafter.

During April 2015, the Company entered into an agreement, through a wholly owned subsidiary, to earn a 75% working interest and a 52.5% net revenue interest, as to the Olmos formation only, in certain leases covering initially 640 gross mineral acres in LaSalle County, Texas. Under the terms of this agreement, the Company was required to commence drilling a well (paying 100% of the cost) on this acreage by late September 2015 or pay liquidated damages of \$500,000. Due to the severe drop in commodity prices, the Company declared the agreement to be in a state of “force majeure” in accordance with the applicable terms of the agreement, effectively placing its obligations on hold until market conditions improve sufficiently to allow for economic development of the acreage. The farmor disputed this declaration and filed suit to enforce the liquidated damages clause of the agreement. In June 2016 the court upheld the farmor’s motion for summary judgement. Accordingly the Company has recorded a provision in the amount of the asserted liquidated damages. The Company will continue to vigorously defend its position. The Company believes this suit to be without merit, intends to appeal the court ruling, and has counter-sued the farmor for damages relating to breach of contract.

#### *Seismic Data Acquisition*

In June, 2014, the Company acquired a non-exclusive license to 3-D seismic data for \$1.1 million. This data covers the southern portion of the farmout acreage in the Big Wells Project and is a critical analytical tool used for optimizing drilling locations on the project. In August, 2014, the Company expanded this purchase to include additional data covering the remainder of the farmout acreage in the Big Wells Project. The company paid an additional license fee of \$1.2 million for this data set. The additional data is part of a multi-year commitment to purchase multiple data sets at a volume discounted rate.

The additional data is to be selected at the Company’s discretion to aid in the evaluation of the expansion of its existing projects (including offsetting acreage surrounding its STS Olmos Project) and/or new projects developed over the next two years. Under the current agreement, the Company was committed to purchase additional data in each of 2015 and 2016 at a cost of \$2,362,500 per year; however, the Company is currently reassessing its data requirements in light of the current commodity price environment. Consequently, the Company has notified the data provider that it does not intend to take advantage of the discounted pricing and that the Company does not expect to purchase the remaining data under the agreement.

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**Results of Operations**

***For the three months ended April 30, 2016 and 2015***

Net loss for the three months ended April 30, 2016 was \$1,310,782 compared to net loss of \$4,960,489 for the three months ended April 30, 2015. The results are summarized as follows:

	2016	2015
Continuing operations:		
Equity income (loss) in partnership	\$ (38,035)	\$ (66,015)
Expenses		
General and administrative expenses	330,284	748,683
Depreciation	14,868	17,642
Financing costs	787,690	712,495
Impairment	-	375,516
Provision for contract litigation	500,000	
Foreign exchange (gain) loss	(2,197,944)	1,460,659
Share-based payments	-	3,072
	<u>(565,102)</u>	<u>3,318,067</u>
Net income (loss) from continuing operations	<u>527,067</u>	<u>(3,384,082)</u>
Discontinued operations:		
Oil and gas revenues (net of royalties)	299,689	1,936,312
Expenses		
Direct operating expenses		
Production and operating	565,984	450,458
Depreciation and depletion	-	1,730,689
Other expenses		
Financing	1,459,205	1,031,474
Salaries and benefits	112,349	300,098
Total expenses	<u>2,137,538</u>	<u>3,512,719</u>
Net loss from discontinued operations, net of tax	(1,837,849)	(1,576,407)
Net loss for the period	<u>\$ (1,310,782)</u>	<u>\$ (4,960,489)</u>

***Continuing operations***

*Equity income (loss) in partnership* represents the Company's pro-rata share of income or loss of the BlackBrush Terrace LP. For the quarter ended April 30, 2016 the Company's share of the partnership loss was \$38,035

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compared to the Company's share of the partnership net loss of \$66,015 for the quarter ended April 30, 2015.

*General and administrative expenses* for the three months ended April 30, 2016 were \$330,284 compared to \$748,683 for the three months ended April 30, 2015. These expenses are comprised primarily of office costs, including rent, executive and other salaries, professional fees for legal and audit services, transfer agent and Exchange fees and investor relations activities. The decrease was primarily due to reductions in administrative and personnel costs as a result of aggressive cost cutting measures taken by the Company during the quarter. After the allocation of salaries and benefits expense to discontinued operations, salaries and benefits expense decreased to \$107,473 for the three months ended April 30, 2016 from \$200,065 for comparative period in the prior year. This was due to staff reductions and reductions in salaries and consulting income in the amount of \$91,052 which offset salaries expense in the current period.

*Financing costs* for the three months ended April 30, 2016 related to continuing operations were \$787,690 compared to \$712,495 for the three months ended April 30, 2015 and represents the cash interest on the convertible notes as well as the accretion of discount. Subsequent to April 30, 2016, the notes were restructured and the cash interest recorded during the period was forgiven as a component of the agreement.

*Impairment* for the three months ended April 30, 2016 was \$nil compared to \$375,516 for the three months ended April 30, 2015. During the three months ended April 30, 2015, the company recognized an impairment to write off the remaining carrying cost of the Big Wells project.

*Provision for contract litigation* for the three months ended April 30, 2016 was related to a contract dispute which the Company entered into to earn acreage to earn a 75% working interest and a 52.5% net revenue interest, as to the Olmos formation only, in certain leases covering initially 640 gross mineral acres in LaSalle County, Texas. Under the terms of this agreement, the Company was required to commence drilling a well (paying 100% of the cost) on this acreage by late September 2015 or pay liquidated damages of \$500,000. Due to the severe drop in commodity prices, the Company declared the agreement to be in a state of "force majeure" in accordance with the applicable terms of the agreement, effectively placing its obligations on hold until market conditions improve sufficiently to allow for economic development of the acreage. The farmor disputed this declaration and filed suit to enforce the liquidated damages clause of the agreement. In June 2016 the court upheld the farmor's motion for summary judgement. Accordingly the Company has recorded a provision in the amount of the asserted liquidated damages. The Company will continue to vigorously defending its position. The Company believes this suit to be without merit, intends to appeal the court ruling, and has counter-sued the farmor for damages relating to breach of contract.

*Foreign exchange gain* for the three months ended April 30, 2016 was \$2,197,944 compared to a loss of \$1,460,659 for the three months ended April 30, 2015. The change in foreign exchange was due to fluctuations in the USD exchange rate during the period.

*Share-based payments* for the three months ended April 30, 2016 were \$nil compared to \$3,072 for the three months ended April 30, 2015 due to the timing of granting stock options and their related vesting periods during the current period compared to the prior period.

*Discontinued operations*

*Oil and gas sales* for the three months ended April 30, 2016 were \$311,197 less royalties of \$11,508 compared to \$2,045,039 less royalties of \$108,727 for the three months ended April 30, 2015.

The Company's aggregate share of sales from these wells before deducting for royalty for the three months ended April 30, 2016 was approximately 14,842 barrels of oil and liquids at an aggregate average price of \$18.09 per barrel of oil equivalent and 26,686 thousand cubic feet of natural gas at an average price of \$1.60 per thousand

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cubic feet. During the previous period the Company's aggregate share of sales from these wells before deducting for royalty was approximately 51,974 barrels of oil and liquids at an average price of \$34.31 per barrel of oil equivalent and 117,869 thousand cubic feet of natural gas at an average price \$2.22 per thousand cubic feet.

*Production and operating expenses* for the three months ended April 30, 2016 were \$565,984 compared to \$450,458 for the three months ended April 30, 2015. The increase is due to field studies being completed as well as payment made to the lease owner to modify the lease to eliminate near term field spending obligations. During the three months ended April 30, 2016 we had 22 wells producing, whereas during the three months ended April 30, 2015 we had 17 wells producing. Depreciation and depletion expenses was \$nil for three months ended April 30, 2016 due to the classification of the associated assets as held for sale during the period compared to \$1,730,689 for the same period in 2015.

*Financing costs* for the three months ended April 30, 2016 were \$1,459,205 compared to \$1,031,474 for the three months ended April 30, 2015 which is attributable to the interest incurred on the Credit Facility for the development of our STS Olmos project totaling which consisted of net cash interest of \$559,834, default interest due to the declared default of \$338,140 non-cash PIK interest of \$338,140, amortization of financing costs of \$220,525 and accretion of \$2,566. During the quarter ended April 30, 2015 the Company incurred interest expense on the Credit Facility which consisted of cash interest of \$555,180, non-cash PIK interest of \$317,872 and amortization of financing costs of \$158,422.

*Salaries and benefits* allocated to discontinued operations for the three months ended April 30, 2016 were \$112,349 compared to \$300,098 for the three months ended April 30, 2015. These expenses are comprised of executive and other salaries deemed attributable to the operations of the projects within Terrace STS, LLC and Terrace Cutlass LLC. The decrease is due to the significantly reduced activity related to the Terrace STS, LLC assets.

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**Summary of Quarterly Results**

The results of the Company's most recent eight quarters are set out below:

	April 30, 2016	January 31, 2016	October 31, 2015	July 31, 2015 <sup>13</sup>
Revenue (net of royalties) <sup>1</sup>	\$299,689	\$464,771	\$ 877,779	\$ 1,911,533
Net income (loss)	(1,310,782) <sup>2</sup>	(6,634,041) <sup>3</sup>	(10,634,329) <sup>4</sup>	(5,006,864) <sup>5</sup>
Exploration and evaluation <sup>10</sup>	1,496,941	3,695,298	5,676,323	4,232,186
Property and equipment <sup>10</sup>	87,990	9,719,005	21,232,741	21,747,906
Assets held for sale <sup>12</sup>	26,741,217	-	44,642	1,762,845
Investment in partnership <sup>11</sup>	7,453,487	7,471,522	10,941,479	18,016,870
Total assets	37,693,493	27,602,876	46,691,721	58,760,177
Loss per share – basic and diluted	(0.01)	(0.07)	(0.12)	(0.06)

  

	April 30, 2015 <sup>13</sup>	January 31, 2015 <sup>13</sup>	October 31, 2014	July 31, 2014
Revenue (net of royalties) <sup>1</sup>	\$ 1,936,312	\$ 1,439,225	\$ 1,240,376	\$ 1,503,040
Net loss	(4,960,489) <sup>6</sup>	(22,003,877) <sup>7</sup>	(5,197,456) <sup>8</sup>	(1,422,583) <sup>9</sup>
Exploration and evaluation <sup>10</sup>	7,320,129	3,967,983	14,831,197	2,431,915
Property and equipment <sup>10</sup>	20,295,962	19,273,394	18,649,028	14,479,455
Assets held for sale <sup>12</sup>	1,762,845	1,762,845	-	9,658,593
Investment in partnership <sup>11</sup>	18,079,869	16,622,882	19,942,870	17,574,581
Total assets	66,114,392	70,373,429	90,596,919	75,509,178
Loss per share – basic and diluted	(0.06)	(0.25)	(0.06)	(0.02)

**Notes:**

- 1) Revenue is primarily a result of oil and gas sales less royalties which varies each period depending on the number of wells in production. The revenues are attributable to the Terrace STS assets as well as the Terrace Cutlass assets all of which are reflected in net loss from discontinued operations in the Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2016.
- 2) Net loss during this period includes non-cash deductions of \$14,868 for depreciation and depletion and \$ 2,197,944 for foreign exchange gain.
- 3) Net loss during this period includes non-cash deductions of \$41,870 for depreciation and depletion, \$7,814 for impairments \$(9,796) for loss on disposal of assets held for sale and \$ 1,129,264 for foreign exchange gain.
- 4) Net loss during this period includes non-cash deductions of \$1,124,867 for depreciation and depletion, \$2,030 for impairments, \$1,718,203 for loss on disposal of assets held for sale and \$ 2,429,669 for foreign exchange gain.
- 5) Net loss during this period includes non-cash deductions of \$1,924,390 for depreciation and depletion, \$2,655,593 for impairments and \$ 719,962 for foreign exchange gain.
- 6) Net loss during this period includes non-cash deductions of \$3,072 for share-based payments, \$1,748,331 for depreciation and depletion, \$375,516 for impairments and \$ 1,460,659 for foreign exchange loss.
- 7) Net loss during this period includes non-cash deductions of \$7,596 for share-based payments, \$833,660 for depreciation and depletion, \$12,777,376 for impairments and \$456,422 for foreign exchange loss.
- 8) Net loss during this period includes non-cash deductions of \$29,180 for share-based payments, \$1,847,423 for

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depreciation and depletion, \$2,100,760 for impairments and \$702,667 for foreign exchange gain.

- 9) Net loss during this period includes non-cash deductions of \$41,219 for share-based payments, \$606,883 depreciation and depletion, \$(49,471) for impairments and \$193,273 for foreign exchange gain.
- 10) The fluctuations between Exploration and Evaluation and Property and Equipment are due to the transfers of the Company's share of the costs to drill, evaluate and case the wells related to the STS Olmos project and the Cutlass project.
- 11) The Company entered into an agreement with BlackBrush Oil and Gas, LP. The carrying value represents the Company's share of costs to organize, acquire and fund certain agreed upon exploration and evaluation activities to-date plus the Company's share of the changes in net assets of the partnership. The Company has recasted comparative information as at January 31, 2014 for the investment in partnership, to present the functional currency of SPLP as USD. As a result the investment in partnership and translation reserve increased by \$1,284,633 at January 31, 2015. The recast of comparative information had no impact on cash flows and the results of operations, except for comprehensive loss. The investment arose during the year-end January 31, 2014; accordingly there was no impact to the financial statements for the year ended January 31, 2013.
- 12) As of January 31, 2014 the Company reclassified costs associated with Cutlass to assets held for sale. At October 31, 2015 the Company reclassified costs associated with Cutlass out of assets held for sale due to a dispute with the project operator over the Company's interest in the property resulting in uncertainty regarding a potential sale. During April 2015 the dispute was settled and the uncertainties were resolved. Accordingly, the Company reclassified the Cutlass property to assets held for sale at January 31, 2015.
- 13) As of October 31, 2015 the Company restated Net Income, Exploration and Evaluation, Property and Equipment, Total Assets and Loss per share – basic and diluted. See Note 4 to the Company's consolidated financial statements for the years ended January 31, 2016 and 2015 for additional details on the restatement. The Exploration and Evaluation, Property and Equipment and Total Assets have also been restated for the quarters ending April 30, 2015 and July 31, 2015 due to the impact on the beginning balance of the assets. There was no impact to net income or and loss per share – basic and diluted to these respective quarters as a result of the restatement of January 31, 2015.

Fluctuations in reported earnings during the prior quarters are primarily due to changes in oil and gas production, depletion and revenues, asset impairment charges, share-based payments, foreign exchange adjustments and professional fees. The time during which the Company acquires, develops, disposes or abandons projects materially impacts the results of operations from fiscal quarter to quarter.

**Financial Condition, Liquidity and Capital Resources**

As at April 30, 2016, the Company had working capital of \$1,222,429 (January 31, 2016 - \$20,377,060). Included in the current assets and liabilities that comprise working capital are the Terrace STS, LLC assets classified as held for sale and associated liabilities. Also included in current liabilities are amounts due under the credit facility within Terrace STS, LLC which is dedicated to the STS Olmos development project in the amount of \$24,292,220 as a result of not being in compliance with certain covenants as of April 30, 2016.

The Company was unable to provide a satisfactory plan to the lender to enhance capitalization of the Terrace STS, LLC entity as required in the May 2015 amendment. In addition, the Company was not in compliance with certain financial covenant requirements beginning with the quarter ended October 31, 2015. As a result, on May 20, 2016, the Company and its Lender completed a transaction whereby the Lender exchanged its outstanding debt contained in the Terrace STS, LLC entity for 95% of the equity of the Terrace STS, LLC entity. See Note 8 to the Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2016 for a more complete description of the transaction. The Terrace STS, LLC entity generated substantially all of the oil & gas revenues for the Company as of April 30, 2016. The Company retained a 5% interest in the Terrace STS, LLC entity, and although the Company will not maintain operating control over the entity, the Company will hold one of the three board positions. In addition, the Company has entered into a management contract to perform the day to day management of the entity for reasonable overhead fees. The proceeds from the contract will be used to offset the G&A of the Company.

As at April 30, 2016 and the date of this report, the Company had outstanding long term convertible notes in the principal amount of CAD \$38,590,000 (April 30, 2015 – CAD \$38,590,000). On May 13, 2016, the Company completed an exchange of the previously outstanding notes which required quarterly interest payments calculated at 8% per annum and were due April 2, 2018 with new non-interest bearing notes, which are secured by the assets of the Terrace Energy Corp. entity with an extended maturity date of April 2, 2021. As part of the exchange, the outstanding, unpaid interest owed to the noteholders was forgiven. A more detailed description of the notes is set out in Note 9 to the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015.

The STS debt for equity exchange and the convertible note exchange have substantially altered the obligations of the Company. The Company will no longer be required to pay accrued interest totaling \$316,911 and the credit facility obligation of \$24,292,220 which are included in current liabilities at April 30, 2016. The Company will no longer pay interest on the Notes and will have an additional three years to settle the principal obligation to the noteholders.

At April 30, 2016, working capital available for general corporate purposes excluding unpaid interest attributable to the convertible notes of \$1,192,458 which was forgiven in May 2016 and excluding amounts dedicated to Terrace STS, LLC which are classified as held for sale and amounts attributable to the Credit Facility at April 30, 2016 was \$1,283,053 which was comprised of cash of \$1,798,814, accounts receivable of \$36,390 and prepaid expense of \$53,654, offset by accounts payable of \$605,805.

The Company funded its minor development costs for the quarter ended April 30, 2016 through cash on hand and cash generated from operations. During the period, the Credit Facility was paid down by \$1,709,820 using available cash in the Terrace STS, LLC entity compared to no financing cash flows in the quarter ending January 31, 2015.

For the quarter ended April 30, 2016, the Company reported a net loss of \$1,310,782. Additionally, the Company had negative cash flow from operating activities for the quarter ended April 30, 2016 and the year ended January 31, 2016. Terrace's financial resources will not be sufficient to fund its debt obligations and ongoing activities



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beyond the near term (see Note 15 in the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015 for a description of the commitments). These conditions indicate the existence of material uncertainties that may cast significant doubt about the Company's ability to continue as a going concern. The Company will need to sell assets and/or raise additional capital or seek other strategic alternatives to meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. There are no guarantees that the Company will be able to sell assets or raise such additional capital when needed.

Following the completion of the STS transaction, the Company has no means to generate cash flow from operations and will require additional funding to fund any commitments related to its Maverick County Project and to drill and complete any wells at its STS Olmos South Lease in order to generate revenues in the future. There are no guarantees that the Company will be able to raise such additional capital as needed.

Additional commitments as described more fully in Note 15 of the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015 now consist primarily of general and administrative related obligations. The Company has taken steps to reduce general and administrative expenditures and will continue to evaluate and take additional measures as deemed prudent to preserve the unrestricted working capital it has as of April 30, 2016 and to protect its core assets until such time as market conditions become more favorable. Beyond the near term commitments, additional equity or other sources of capital will be required to meet the Company's obligations as they become due and there are no guarantees that such additional capital funding will be available when needed.

**Off Balance Sheet Arrangements**

Except as described herein, there are no off-balance sheet arrangements to which the Company is committed.

**Key Management Personnel Compensation**

Key management personnel include executive officers and directors of the Company. Compensation of the Company's key management personnel is comprised of the following:

	<b>Three months ended April 30,</b>	
	<b>2016</b>	<b>2015</b>
Short-term compensation		
CEO	\$ 60,300	\$ 90,000
CFO (current and previous)	49,413	73,750
COO	57,704	81,250
VP Exploration	37,483	50,000
VP Geosciences	30,583	50,000
Secretary	7,048	15,981
Share-based payments	-	1,536
	<b>\$ 242,531</b>	<b>\$ 362,517</b>

As at April 30, 2016 and 2015:

- (a) included in accounts receivable as at April 30, 2015 are advances to key management personnel totalling \$47,562 paid to successfully defend the Company's president's and one of the Company's other board member's reputation from a spurious lawsuit on their behalf, as well as on behalf of the Company. During

the year ended January 31, 2016, the Company determined the amount advanced previously to be an expense of the Company and charged the amount to administrative expense.

- (b) convertible notes held by key management personnel totalled CAD \$3,230,000 (2015 - CAD \$3,230,000). Interest paid on the convertible notes held by key management personnel and their close family members totalled \$48,674.

### **Proposed transactions**

There are no proposed transactions that have not been disclosed herein.

### **New Accounting Pronouncements**

The IASB or IFRIC have issued pronouncements effective for accounting periods beginning on or after January 1, 2015. Only those that may significantly impact the Company are discussed below:

#### **IFRS 9 Financial Instruments (2014)**

IFRS 9 contains accounting requirements for financial instruments and replacing IAS 39 Financial Instruments: Recognition and Measurement. The standard contains requirements in the following areas:

- Classification and measurement. Financial assets are classified by reference to the business model within which they are held and their contractual cash flow characteristics. The 2014 chapter of IFRS 9 introduces a “fair value through other comprehensive income” category for certain debt instruments. Financial liabilities are classified in a similar manner to under IAS 39; however, there are differences in the requirements applying to the measurement of an entity's own credit risk.
- Impairment. The 2014 chapter of IFRS 9 introduces an “expected credit loss” model for the measurement of the impairment of financial assets, so it is no longer necessary for a credit event to have occurred before a credit loss is recognized.
- Hedge accounting. Introduces a new hedge accounting model that is designed to be more closely aligned with how entities undertake risk management activities when hedging financial and non-financial risk exposures.
- Derecognition. The requirements for the derecognition of financial assets and liabilities are carried forward from IAS 39.

Applicable to annual periods beginning on or after January 1, 2018. The Company has not assessed the impact of this pronouncement.

#### **IFRS 15 Revenue from Contracts with Customers**

IFRS 15 provides a single, principles based five-step model to be applied to all contracts with customers.

The five steps in the model are as follows:

- Identify the contract with the customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contracts
- Recognize revenue when (or as) the entity satisfies a performance obligation.

Guidance is provided on topics such as the point in which revenue is recognized, accounting for variable consideration, costs of fulfilling and obtaining a contract and various related matters. New disclosures about revenue are also introduced.

Applicable to annual periods beginning on or after January 1, 2018. The Company has not assessed the impact of this pronouncement.

#### **IFRS 16 Leases**

IFRS 16 specifies how an IFRS reporter will recognize, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. Lessors continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting substantially unchanged from its predecessor, IAS 17 Leases.

Applicable to annual periods beginning on or after January 1, 2019. The Company has not assessed the impact of this pronouncement.

#### **Critical accounting estimates**

The preparation of the condensed consolidated interim financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets and liabilities, revenues and expenses. Actual results may differ from these estimates.

Following are the accounting policies subject to such judgments and the key sources of estimation uncertainty that the Company believes could have the most significant impact on the reported results and financial position.

##### *Functional currency*

The determination of the functional currency for the Company and each of its subsidiaries was based on management's judgment of the underlying transactions, events and conditions relevant to each entity.

##### *Reserves*

The estimate of oil and natural gas reserves is integral to the calculation of the amount of depletion charged to the condensed consolidated interim statements of operations and comprehensive loss and is also a key determinant in assessing whether the carrying value of any of the Company's development and production assets have been impaired. Changes in reported reserves can impact asset carrying values and the decommissioning provision due to changes in expected future cash flows. The Company's reserves are evaluated and reported on by independent reserve engineers at least annually in accordance with Canadian Securities Administrators' National Instrument 51-101 *Standards of Disclosure of Oil and Gas Activities* ("NI 51-101"). Reserve estimation is based on a variety of factors including engineering data, geological and geophysical data, projected future rates of production, commodity pricing and timing of future expenditures, all of which are subject to significant judgment and interpretation.

##### *Carrying value of property and equipment and exploration and evaluation assets*

The Company assesses at each reporting date whether there is an indication that an asset or cash-generating unit ("CGU") may be impaired. A CGU is defined as the lowest grouping of assets that generate identifiable cash inflows that are largely independent of cash inflows of other assets or groups of assets. The allocation of assets into CGUs requires significant judgment and interpretation with respect to the way in which management

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monitors operations. If any indication exists that an asset or CGU may be impaired, the Company estimates the recoverable amount. The recoverable amounts of individual assets and CGUs have been determined based on the higher of value-in-use calculations and fair value less costs to sell. These calculations require the use of estimates and assumptions, such as estimates of proved plus probable reserves, future production rates, oil and natural gas prices, future costs and other relevant assumptions, all of which are subject to change.

A material adjustment to the carrying value of the Company's property and equipment and exploration and evaluation assets could arise as a result of changes to these estimates and assumptions.

*Assets held for sale*

Judgment is required in determining whether an asset meets the criteria for classification as "assets held for sale" in the consolidated statements of financial position. Criteria considered by management include the existence of and commitment to a plan to dispose of the assets, the expected selling price of the assets, the expected timeframe of the completion of the anticipated sale and the period of time any amounts have been classified within assets held for sale. The Company reviews the criteria for assets held for sale each quarter and reclassifies such assets to or from this balance sheet category as appropriate. In addition, there is a requirement to periodically evaluate and record assets held for sale at the lower of their carrying value and fair value less costs to sell. Depreciation and depletion

Depletion of oil and gas properties is provided using the unit-of-production method based on production volumes before royalties in relation to total estimated proved reserves as determined annually by independent engineers and internal reserve evaluations on a quarterly basis. Natural gas reserves and production are converted at the energy equivalent of approximately six thousand cubic feet to one barrel of oil.

*Accounts receivable*

Accounts receivable are recorded at the estimated recoverable amount, which involves the estimate of uncollectible accounts.

*Decommissioning obligations*

Amounts recorded for decommissioning obligations require the use of management's best estimates of future decommissioning expenditures, expected timing of expenditures and future inflation rates. The estimates are based on internal and third party information and calculations are subject to change over time and may have a material impact on profit and loss or financial position.

*Share-based payments*

The fair value of share-based payments is subject to the limitations of the Black-Scholes option pricing model that incorporates market data and involves uncertainty in estimates used by management in the assumptions. Because the Black-Scholes option pricing model requires the input of highly subjective assumptions, including the volatility of share prices, changes in subjective input assumptions can materially affect the fair value estimate.

**Risk Factors**

Management of the Company considers the following risks to be the most significant in connection with the business and outlook for the Company, but such risks do not necessarily comprise all those associated with the Company's operations. Additional risks and uncertainties not currently known to management of the Company may also have an adverse effect on the Company's business. If any of these risks actually occur, the Company's business, financial condition, capital resources, results and/or future operations could be materially adversely

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affected. In such a case, the market value of the securities of the Company could decline and investors may lose all or part of their investment.

**Additional Funding Requirements and Going Concern**

For the three months ended April 30, 2016, the Company reported a net loss of \$1.3 million and had working capital of \$1,222,429. The working capital is impacted by the classification of the Terrace STS, LLC assets and liabilities as held for sale and the \$24.3 million of debt related to the Company's secured credit facility as a current liability due to non-compliance with certain covenants under the facility as of April 30, 2016. Additionally, the Company had negative cash flow from operating activities in the financial three months ended April 30, 2016 and 2015. Terrace's financial resources will not be sufficient to fund its long-term convertible note obligations and ongoing activities beyond the near term (see commitments described under "Exploration and Development Assets"). These conditions indicate the existence of material uncertainties that may cast significant doubt about the Company's ability to continue as a going concern. The Company will need to sell assets and/or raise additional capital to meet its note obligations and to carry out its future oil and gas acquisition, exploration and development activities. Failure to obtain such capital on a timely basis could cause the Company to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. Any additional financing is likely to involve the issuance of securities which could be substantially dilutive.

As at April 30, 2016 and the date of this report, the Company had outstanding long term convertible notes in the principal amount of CAD \$38,590,000 (April 30, 2015 – CAD \$38,590,000). On May 13, 2016, the Company completed an exchange of the previously outstanding notes which required quarterly interest payments calculated at 8% per annum and were due April 2, 2018 with new non-interest bearing notes, which are secured by the assets of the Terrace Energy Corp. entity with an extended maturity date of April 2, 2021. As part of the exchange, the outstanding, unpaid interest owed to the noteholders was forgiven. A more detailed description of the notes is set out in Note 9 to the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015.

As of April 30, 2016, Terrace STS, LLC (a wholly-owned subsidiary of the Company) had \$24,292,220 outstanding under the Credit Facility. During May 2016, the amounts outstanding under the Credit Facility were exchanged for 95% of the equity of the Terrace STS, LLC entity. See Note 8 to the Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2016 for a more comprehensive description of the transaction.

The Company's ability to meet its current and future debt obligations and to fund its operations, including its obligations in order to earn into its project interests, will depend on numerous factors, including the ability to sell assets and/or raise additional capital, the success of its acquisition activities, development and exploration drilling success, cost of lease extensions and renewals, the cost and rates of success of re-completing or drilling wells, future production levels, the terms (including price) and conditions that it is able to negotiate with purchasers of production from its properties, and the results of exploration activities. None of these factors can be predicted with certainty. Accordingly, the timing and amount of required capital may vary from management expectations. In addition, the Company may be required by the holders of the outstanding convertible promissory notes to pre-pay the outstanding principal amount owing under the notes if an event of default under the notes occurs. As a result, in such circumstances the Company may be required to pay the entire outstanding principal owing on the notes in advance of the maturity date of April 2, 2021, failing which the note holders could take action to realize on their general security interest over the Company's assets. Further, because the Company's operations are conducted through U.S. subsidiaries, the Company's ability to meet its debt service obligations with cash from operations will depend on generating cash flows from operations of its U.S. subsidiaries and may be subject to contractual or other restrictions and other business considerations.

Any additional equity financing will be dilutive to the holders of the Company's outstanding common shares and may not be on terms that the Company finds attractive, if available at all. Any additional debt financing, if available, may restrict the Company's future financing and operating activities. The Company may be unable to obtain additional financing on acceptable terms if market and economic conditions, the financial condition or operating performance of the Company or investor sentiment are unfavourable. If the Company's cash flow is insufficient to meet its current and future debt obligations or if the Company fails to obtain sufficient funds for operations and earn in obligations on a timely basis, the Company may have to forfeit its interest in certain properties, sell assets, miss certain acquisition opportunities, and reduce or terminate its acquisition, exploration and development programs, which would have a material adverse effect on the Company's results of operations and could result in a loss of some projects. The inability of the Company to meet its current and future debt obligations or to fund its operations could have a material adverse effect on the Company's financial condition, results of operations and prospects.

#### Prices and Markets for Oil and Natural Gas

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors, all of which will be beyond the control of the Company. World prices for oil and natural gas have fluctuated widely in recent years and have dropped precipitously since late 2014. The recent decline in prices has resulted in a significant reduction of net production revenue. Additional decreases could result in further decreases of revenue. Certain wells have become uneconomic as a result of a decline in world oil prices or natural gas prices, leading to a reduction in the volume of the Company's oil and gas reserves. Additional material declines would result in more wells becoming uneconomic with corresponding reductions to reserves. The Company might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in the Company's future net production revenue, causing a reduction in its oil and gas acquisition and development activities. Prices for oil and gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and gas, market uncertainty and a variety of additional factors beyond the control of the Company. These factors include economic conditions, in the United States and Canada, the actions of OPEC, governmental regulation, political stability in the Middle East and elsewhere, the foreign supply of oil and gas, risks of supply disruption, the price of foreign imports and the availability of alternative fuel sources. Any substantial and extended decline in the price of oil and gas would have an adverse effect on the Company's carrying value of its reserves, borrowing capacity, revenues, profitability and cash flows from operations and may have a material adverse effect on the Company's business, financial condition, results of operations and prospects.

#### Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration by the Company will result in new discoveries of oil or natural gas in commercial quantities. The Company, through its subsidiaries, has the right to earn working interests in various oil and gas properties described herein. To earn such interests the Company must incur certain specified expenditures to evaluate and complete a number of prospective wells capable of producing oil and gas in paying quantities. No assurance can be given that the Company will be successful in completing wells capable of producing oil and gas. The long-term commercial success of the Company depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Without the continual addition of new reserves, any existing reserves the Company may have at any particular time and the associated production if any there from will decline over time as the reserves are exploited. A future increase in the Company's reserves will depend not only on its ability to explore and develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. No assurance can be given that the Company will be able to continue to locate satisfactory properties for acquisition or participation. Exploration and development activities may be delayed or adversely affected by factors outside the control of the Company including adverse climatic and geographic conditions, labour disputes, compliance with governmental requirements, shortage or delays in installing and

commissioning plant and equipment or import or customs delays. Drilling may involve unprofitable efforts, not only with respect to dry wells, but also with respect to wells, though yielding some oil or gas, are not sufficiently productive to justify commercial development or cover operating and other costs. Oil and natural gas exploration, development and production operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts, cratering, sour gas releases and spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury.

#### No Assurance of Title

Title to oil and gas interests is often not capable of conclusive determination without incurring substantial expense. The nature of the oil and gas leasing and title regime in the U.S. is such that interests in tracts of acreage may be represented by many leases and other agreements affecting oil and gas rights and access and obtaining absolute confirmation of chain of title would be time consuming and expensive. While the Company will conduct a title review of a particular area prior to commencement of drilling there can be no assurance of title. Title may be subject to unregistered liens and other defects which, if affecting a core area, could have a material adverse effect on the Company, its financial condition, results of operations and prospects.

#### Permits and Licenses

The activities of the Company are subject to government approvals, various laws governing prospecting, development, land resumptions, production taxes, labor standards and occupational health, safety, toxic substances and other matters, including issues affecting local native populations. Although the Company believes its planned development work is in accordance with all applicable rules and regulations, no assurance can be given that new rules and regulations will not be enacted or that existing rules and regulations will not be applied in a manner which could limit or curtail production or development. Amendments to current laws and regulations governing operations and activities of oil and gas exploration and development, or more stringent implementation thereof, could have a material adverse impact on the business, operations and financial performance of the Company. Further, the exploration and development permits and licenses that have and may be issued in respect of each project may be subject to conditions which, if not satisfied, may lead to the revocation of such permits and licenses. In the event of revocation, the value of the Company's investments in such projects may decline.

#### Hydraulic Fracturing

Hydraulic fracturing is a common practice that is used to stimulate production of hydrocarbons from shale and tight formations. The projects in which the Company is currently engaged are heavily dependent on hydraulic fracturing. The process involves the injection of water, sand and chemicals under pressure into rock formations to fracture the surrounding rock and stimulate production.

Certain U.S. states, including Texas, and municipalities have adopted, or are considering adopting, regulations that have imposed, or that could impose, more stringent permitting, disclosure, disposal and well construction requirements on hydraulic fracturing operations. If new laws or regulations that significantly restrict or regulate hydraulic fracturing are adopted, such legal requirements could cause project delays and make it more difficult or costly for the Company to perform fracturing to stimulate production from a formation. The development of natural gas and oil reserves from shale and tight formations in which the Company has or may in the future have an interest may not be commercial without the use of hydraulic fracturing, and therefore any restrictions imposed on the Company's use of hydraulic fracturing could have a material adverse effect on the Company's cash flows and financial condition. Restrictions on hydraulic fracturing could reduce the amount of natural gas and oil that the Company is ultimately able to produce from its reserves.

#### Reserve Estimates

There are numerous uncertainties inherent in estimating quantities of oil, natural gas and natural gas liquids reserves and resources and associated cash flows, including many factors beyond the Company's control. In general, estimates of economically recoverable oil and natural gas reserves and the future net cash flows from them are based upon a number of variable factors and assumptions, such as historical production from the properties, production rates, ultimate reserve recovery, timing and amount of capital expenditures, marketability of oil and natural gas, royalty rates, the assumed effects of regulation by governmental agencies and future operating costs, all of which may vary from actual results. The Company's actual production, revenues, taxes and development and operating expenditures with respect to its reserves will vary from estimates thereof and such variations could be material.

#### Lack of Adequate Insurance

In the course of exploration, development and production of oil and gas properties, certain risks, and in particular, unexpected or unusual geological operating conditions including rock bursts, cave-ins, fires, flooding and earthquakes may occur. It is not always possible to fully insure against such risks and the Company may decide not to take out insurance against such risks as a result of high premiums or other reasons. Should such liabilities arise, they could reduce or eliminate any future profitability and result in increasing costs and a decline in the value of the securities of the Company.

#### Competition

The oil and gas industry is highly competitive. The Company's competitors for the acquisition, exploration, production and development of oil and natural gas properties, and for capital to finance such activities will include companies that have greater financial and personal resources available to them than the Company.

#### Reliance upon Third Party Operators and Risks Associated with Joint Operating Agreements

The Company is not the operator on any of its projects. The Company therefore has limited ability to exercise influence over operations of the projects or their associated costs. The Company's dependence on the operator and other working interest owners and its limited ability to influence operations and associated costs could materially and adversely affect the Company's financial performance. The success and timing of the Company's activities on assets operated by others therefore will depend upon a number of factors outside of the Company's control, including the timing and amount of capital expenditures, timing and amount of operating and maintenance expenditures, the operator's expertise and financial resources, approval of and funding by other participants, selection of technology and risk management practices.

In addition, the Company owns certain of its interests, including its interests in the Maverick County Project, through joint venture or similar arrangements. Joint ventures involve risks not otherwise present when exploring and developing properties directly, including, for example, that the joint venture partner may not pay its share of obligations, the Company may incur liabilities as a result of an action taken by its joint venture partners and the Company may be required to devote significant management time to the requirements.

Disputes with third party operators, joint venture partners and other participants in projects may result in delays, litigation or operational impasses. The risks described above or the failure to resolve disagreements could result in significant cost and delay, or adversely affect the ability of the parties to operate and develop the relevant projects, which would have a material adverse effect on the Company.



### Environmental Risks

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and federal, state and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. There is no assurance that future changes in environmental regulation, if any, will not adversely affect the Company's operations or prevent operations all together. Government approvals and permits are currently, and may in the future be, required in connection with the Company's operations, which could potentially make operations expensive or prohibit them altogether. To the extent such future approvals are required and not obtained, the Company may be curtailed or prohibited from proceeding with planned exploration or development of its projects or from commencing production.

### Availability of Drilling Equipment and Access Restrictions

Oil and natural gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to the Company and may delay exploration and development activities.

### Global Financial Conditions

Following the onset of the credit crisis in 2008, global financial conditions were characterized by extreme volatility and several major financial institutions either went into bankruptcy or were rescued by governmental authorities. While global financial conditions subsequently stabilized, there remains considerable risk in the system given the extraordinary measures adopted by government authorities to achieve that stability. The deteriorating financial condition of certain government authorities has significantly increased the potential for sovereign defaults in a number of jurisdictions, including within the member states of the European Union. Global financial conditions could suddenly and rapidly destabilize in response to future economic shocks, as government authorities may have limited resources to respond to future crises. Future economic shocks may be precipitated by a number of causes, including changes in commodity prices, geopolitical instability and natural disasters.

Global financial conditions continue to be subject to increased volatility. Many industries, including the oil and gas industry, are impacted by global market conditions. Some of the key impacts of financial market turmoil can include contraction in credit markets resulting in a widening of credit risk, devaluations and high volatility in global and specifically natural resource equity markets, commodity, foreign exchange and precious metal markets, and a lack of market liquidity. A slowdown in the financial markets or other economic conditions, including but not limited to, reduced consumer spending, increased unemployment rates, deteriorating business conditions, inflation, deflation, volatile fuel and energy costs, increased consumer debt levels, lack of available credit, lack of future financing, changes in interest rates and tax rates may adversely affect the Company's operations and business plans. Any of these factors may impact the ability of the Company and its joint venture partners or potential partners to obtain equity or debt financing in the future and, if obtained, on favourable terms. Additionally, any such occurrence could cause decreases in asset values that are deemed to be other than temporary, which may result in impairment losses.

#### Geo Political Risks

The marketability and price of oil and natural gas that may be acquired or discovered by the Company is and will continue to be affected by political events throughout the world that cause disruptions in the supply of oil. Conflicts, or conversely peaceful developments, arising in the Middle East, and other areas of the world, have a significant impact on the price of oil and natural gas. Any particular event could result in a material decline in prices and therefore result in a reduction of the Company's net production revenue.

#### Transportation Costs

Disruption in or increased costs of transportation services could make oil and natural gas a less competitive source of energy or could make the Company's oil and natural gas less competitive than other sources. The industry depends on rail, trucking, ocean-going vessels, pipeline facilities, and barge transportation to deliver shipments, and transportation costs are a significant component of the total cost of supplying oil and natural gas. Disruptions of these transportation services because of weather related problems, strikes, lockouts, delays or other events could temporarily impair the ability to supply oil and natural gas to customers and may result in lost sales. In addition, increases in transportation costs, or changes in transportation costs for oil and natural gas produced by competitors, could adversely affect profitability. To the extent such increases are sustained, the Company could experience losses and may decide to discontinue certain operations forcing the Company to incur closure and/or care and maintenance costs, as the case may be. Additionally, lack of access to transportation may hinder the expansion of production at some of the Company's properties and the Company may be required to use more expensive transportation alternatives.

#### Capacity of Pipelines, Refineries and Natural Gas Processing Facilities

Although expansion projects are ongoing, the availability of sufficient marketing capacity continues to affect the oil and natural gas industry and limit the ability to produce and to market natural gas production. The rapid expansion of production in the Company's core area may create temporary disruptions in the capacity of marketing infrastructure.

#### Reliance on Key Individuals

The Company's success depends to a certain degree upon certain key members of the management team. It is expected that these individuals will be a significant factor in the Company's growth and success. The loss of the service of members of management and certain key employees could have a material adverse effect on the Company.

#### Conflicts of Interest

Certain of the Company's directors are also directors, officers or shareholders of other companies that are engaged in the business of acquiring, developing and exploiting natural resource properties. Such associations may give rise to conflicts of interest from time to time. Such a conflict poses the risk that the Company may enter into a transaction on terms which place the Company in a worse position than if no conflict existed. The directors are required by law to act honestly and in good faith with a view to the best interest of the Company and to disclose any interest which they may have in any project or opportunity of the Company. However, each director has similar obligations to other companies for which such director serves as an officer or director. If a conflict of interest arises at a meeting of the board of directors, any director in a conflict is required disclose his interest and abstain from voting on such matter. In determining whether or not the Company will participate in any project or opportunity, the board of directors will primarily consider the degree of risk to which the Company may be exposed and its financial position at that time.

### **Financial Instruments**

The Company has classified its financial instruments as follows:

- Cash and restricted cash– as FVTPL;
- Accounts receivable and operators bond – as loans and receivables; and
- Accounts payable and accrued liabilities, liabilities associated with assets held-for-sale and convertible notes – as other financial liabilities.

The Company's risk exposure and the impact on the Company's financial instruments are summarized below:

#### **Fair value**

The carrying values of accounts receivable, accounts payable and accrued liabilities, and liabilities associated with assets held-for-sale approximate their fair values due to the short-term maturity of these financial instruments. The fair value of the operators bond also approximates its carrying value. The debt component of the convertible notes was recognized initially at fair value and thereafter has been accounted for at amortized cost.

#### **Credit risk**

Credit risk is the risk of potential loss to the Company if the counterparty to a financial instrument fails to meet its contractual obligations.

The Company's credit risk is primarily attributable to its cash and accounts receivable. The credit risk associated with cash is mitigated since the cash is held at major financial institutions with high credit ratings. Accounts receivable consists primarily of trade receivables outstanding from operators of its oil and gas interests. To mitigate this risk, the Company regularly reviews the collectability of accounts receivable to ensure there is no indication that these amounts will not be fully recoverable.

#### **Market risk**

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in the market prices. Market risk is comprised of three types of risk: interest rate risk, foreign currency risk and other price risk.

##### **(i) Interest rate risk**

To the extent that payments made or received on the Company's monetary assets and liabilities are affected by changes in prevailing market interest rates, the Company is exposed to interest rate cash flow risk.

To the extent that changes in prevailing market interest rates differ from the interest rates in the Company's monetary assets and liabilities, the Company is exposed to interest rate price risk.

The Company's exposure to interest rate risk is minimal.

##### **(ii) Foreign currency risk**

Foreign currency risk is the risk that the future cash flow of financial instruments will fluctuate as a result of changes in foreign exchange rates. The Company's financing is raised in Canadian dollars, but a portion of the Company's operations are conducted in United States dollars. Therefore, the Company is impacted by changes in the exchange rate between the Canadian and United States dollars.

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The following assets and liabilities represent the Company's exposure to foreign currency risk:

	<b>April 30, 2016</b>	<b>January 31, 2016</b>
	<b>(USD)</b>	<b>(USD)</b>
Cash	\$ 1,728,437	\$ 2,075,512
Accounts receivable	-	6,800
Operators bond	25,000	25,000
Accounts payable and accrued liabilities	(538,685)	(8,167)
Net	\$ 1,214,752	\$ 2,099,145

Based on the above net exposure as at April 30, 2016, a 5% change in the Canadian/US exchange rate would impact the Company's net loss and comprehensive loss by approximately \$60,738 (January 31, 2016 - \$104,597). The assets and liabilities with exposure to foreign currency risk are those which are denominated in a different currency than the currency determined to be the functional currency of the respective entity as of the end of the period.

(iii) Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in the market prices, other than those arising from interest rate risk or foreign currency risk. The Company is not exposed to significant other price risk.

Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in satisfying financial obligations as they become due. The Company manages liquidity risk through maintaining sufficient cash on hand to meet its obligations as they become due. Subsequent to quarter end, the amounts outstanding under the credit facility were converted into equity which the previous lender now holds (see Note 8 in the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015). Accordingly, as of the date of this report there are no amounts due under the credit facility. The credit facility has been terminated and the assets and liabilities of Terrace STS are no longer attributable to the Company following the transaction. In addition the Company reached an agreement with its noteholders and the notes outstanding at April 30, 2016 have been exchanged for new notes in the amount of CAD \$38,590,000 that do not pay interest and are due on April 2, 2021. The Company has recorded \$1,192,450 of accrued interest related to the notes at April 30, 2016 which was forgiven at the time of the transaction.

As at April 30, 2016, excluding the assets and liabilities of Terrace STS, LLC which are classified as held for sale at the end of the period, the Company had cash of \$1,798,814, accounts receivable of \$36,930, prepaids of \$53,654 and current liabilities of \$605,813 (excluding the \$1,192,450 of accrued interest forgiven in the note exchange). The current liabilities are due within three months of quarter end.

The Company had negative cash flow from operating activities for the three months ended April 30, 2016 and 2015. Terrace has limited history of production or profitability and its financial resources will not be sufficient to fund its debt obligations and ongoing activities beyond the near term (see Note 15 in the Company's Condensed Consolidated Interim Financial Statements for the three months ended April 30, 2016 and 2015 for a description of the commitments). These conditions indicate the existence of material uncertainties that may cast significant doubt about the Company's ability to continue as a going concern. The Company will need to sell assets and/or raise additional capital or seek other strategic alternatives to meet its debt obligations and to carry out its future oil

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and gas acquisition, exploration and development activities.

The Company owns varying interests in oil and gas properties subject to joint operating agreements, which provide, among other things, that the Company make advance payments from time to time to fund its share of estimated exploration and evaluation costs. The Company has a working capital deficit and available resources combined with future cash flow from operations will not be sufficient to fund its share of the agreed-upon estimated costs of proposed future exploration and development activities. As a consequence, the Company will have to secure new sources of capital, which is not assured, to maintain its interests in such proposed activities and there is no assurance such capital could be obtained.

**Shareholder's Equity and Outstanding Share Data**

The authorized share capital of the Company consists of an unlimited number of common shares. As of April 30, 2016 and the date of this report, there were 87,844,821 common shares outstanding.

During the three months ended April 30, 2016 and 2015, the Company did not issue any new equity and no convertible notes were converted into common shares during the period.

As of the date of this report, the Company had the following stock options and warrants outstanding:

Stock options

<b>Number of Options</b>	<b>Number of Options Exercisable</b>	<b>Exercise Price (CAD)</b>	<b>Expiry Date</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>
1,650,000	1,650,000	\$ 0.12	June 22, 2016	0.15
250,000	250,000	\$ 0.19	July 15, 2016	0.21
250,000	250,000	\$ 0.21	September 16, 2016	0.35
250,000	250,000	\$ 0.19	October 18, 2016	0.46
250,000	250,000	\$ 0.67	December 16, 2016	0.63
150,000	150,000	\$ 1.35	July 8, 2017	1.19
2,800,000	2,800,000			0.30

Warrants

<b>Number of Warrants</b>	<b>Weighted Average Exercise Price (CAD)</b>	<b>Expiry Date</b>
500,000	\$ 0.18	June 21, 2016

Restricted Share Units

The Company has a restricted share unit plan, which provides that the Board of Directors of the Company may from time to time, in its discretion, and in accordance with Exchange requirements, issue to directors, officers, employees and technical consultants to the Company, restricted share units ("RSUs"). The aggregate number of common shares of the Company that may be issued under the plan may not exceed 3,682,182 shares. In addition,

common shares reserved for issuance of RSUs will reduce the number of shares that may be made subject to the incentive stock options under the Company's 10% rolling option plan. The number of common shares reserved for issuance, together with any other compensation arrangements, to any one person in any 12-month period will not exceed 5% of the issued and outstanding common shares. The number of common shares reserved for issuance together with any other compensation arrangements granted to all technical consultants and will not exceed 2% of the issued and outstanding common shares. The number of RSUs granted to any one person cannot exceed 5% of the issued and outstanding common shares.

The Company has issued 1,100,000 RSUs outstanding as of April 30, 2016 (2015 - 1,200,000). Each RSU, upon vesting, gives the holder the right to receive one common share. Unless otherwise approved by the Company's Board of Directors, all of the RSUs will vest upon the occurrence of a "change of control transaction"; as such term is defined in the RSU award agreements. In the absence of a change of control transaction or other acceleration of vesting by the Company's Board of Directors, unvested RSUs will expire ten years from the date of grant. Vested RSUs will be settled, at the election of the Company, by way of: (i) issuance of common shares from treasury; (ii) payment to the RSU holder of an amount of cash equal to the market price of the common shares on the vesting date; or (iii) any combination thereof.

### **Reserves Data and Other Oil and Gas Information**

Our independently prepared reserves assessment and evaluation of oil and gas properties effective January 31, 2016 have been prepared in accordance with mandated National Instrument 51-101 *Standards of Disclosure for Oil and Gas Activities of Canadian Securities Administrators*. A summary of our reports is available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **Internal Controls Over Financial Reporting**

#### **Changes in Internal Control over Financial Reporting ("ICFR")**

In connection with National Instrument 52-109, Certification of Disclosure in Issuer's Annual and Interim Filings ("NI 52-109") adopted in December 2008 by each of the securities commissions across Canada, the Chief Executive Officer and Chief Financial Officer of the Company will file a Venture Issuer Basic Certificate with respect to financial information contained in the unaudited interim financial statements and the audited annual financial statements and respective accompanying Management's Discussion and Analysis. The Venture Issue Basic Certification does not include representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in NI52-109.

### **Contingencies**

There are no contingent liabilities.

### **Management's Responsibility For Financial Statements**

The information provided in this report, including the condensed consolidated interim financial statements, is the responsibility of management. In the preparation of these statements, estimates are sometimes necessary to make a determination of future values for certain assets or liabilities. Management believes such estimates have been based on careful judgments and have been properly reflected in the condensed consolidated interim financial statements.

### **Other MD&A Requirements**

Additional disclosure of the Company's technical reports, material change reports, news releases and other information can be obtained on SEDAR at [www.sedar.com](http://www.sedar.com).

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**Directors and Officers**

David Gibbs	President, Chief Executive Officer and Director
Dan Carriere	Director and Non-Executive Chairman
Eric Boehnke	Director and Executive Vice Chairman
Murray Oliver	Director
William McCartney	Director
Ken Shannon	Director
George Morris	Chief Operating Officer
Keith Godwin	Chief Financial Officer
William McMoran	Vice President Exploration
Daniel Morris	Vice President Geoscience
Anthony Alvaro	Vice President Corporate Development
Deborah Cotter	Secretary

**Contact Person**

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