TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(Unaudited and Expressed in United States Dollars)

FOR THE SIX AND THREE MONTHS ENDED JULY 31, 2016 AND 2015

TERRACE ENERGY CORP.

NOTICE OF NO AUDITOR REVIEW OF CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited condensed consolidated interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these condensed consolidated interim financial statements in accordance with standards established by the Chartered Professional Accountants Canada for a review of interim financial statements by an entity's auditor.

Vancouver, Canada

September 29, 2016

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF FINANCIAL POSITION
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)

	July 31, 2016	January 31, 2016
ASSETS		
Current assets		
Cash	$ 1,383,911	$ 2,301,811
Restricted cash (Note 8)	-	4,038,780
Accounts receivable	93,584	290,684
Prepaids	47,113	60,776
Total current assets	1,524,608	6,692,051
Non-current assets		
Operator's bond	25,000	25,000
Investment in partnership (Note 5)	7,423,134	7,471,522
Investment in Terrace STS (Notes 4 and 8)	1,313,947	-
Exploration and evaluation assets (Note 6)	1,438,695	3,695,298
Property and equipment (Note 7)	71,265	23,257,556
Total assets	$ 11,796,649	$ 41,141,427
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable and accrued liabilities (Notes 9 and 16)	$ 564,635	$ 1,625,736
Credit facility (Note 8)	-	25,443,375
Total current liabilities	564,635	27,069,111
Non-current liabilities		
Convertible notes (Notes 9 and 16)	12,285,928	25,875,415
Decommissioning obligations (Note 10)	-	491,503
Total liabilities	12,850,563	53,436,029
Shareholders' deficit		
Capital stock (Note 11)	47,416,203	47,416,203
Convertible notes – equity component (Note 9)	2,029,170	2,814,173
Stock options reserve (Note 11)	892,179	1,034,242
Warrants reserve (Note 11)	-	6,099
Translation reserve (Note 2)	(4,111,061)	(684,574)
Deficit	(47,280,405)	(62,880,745)
Total shareholders' deficit	(1,053,914)	(12,294,602)
Total liabilities and shareholders' deficit	$ 11,796,649	$ 41,141,427

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)

	For the six months ended July 31, 2016	For the six months ended July 31, 2015	For the three months ended July 31, 2016	For the three months ended July 31, 2015
Equity loss in partnership (Note 5)	$ (68,388)	$ (106,013)	$ (30,353)	$ (39,998)
EXPENSES				
Administrative	207,133	440,211	106,581	215,272
Depreciation	28,275	33,360	13,407	15,718
Gain on note extinguishment	(15,126,653)	-	(15,126,653)	-
Foreign exchange (gain) loss	(2,286,150)	740,697	(88,206)	(719,962)
Impairment (Notes 4 and 7)	-	3,031,109	-	2,655,593
Financing (Note 12)	1,350,031	1,553,540	562,341	841,045
Investor relations	6,284	256,628	77	78,449
Professional	190,783	307,622	107,219	194,305
Provision for litigation (Note 15)	500,000	-	-	-
Salaries and benefits (Note 16)	172,643	397,231	65,170	197,166
Share-based payments (Notes 11 and 16)	-	3,072	-	-
Transfer agent and filing fees	28,938	42,520	(2,650)	16,521
Travel	3,493	13,884	2,593	7,700
	(14,925,223)	6,819,874	(14,360,121)	3,501,807
Net income (loss) from continuing operations for the period	14,856,835	(6,925,887)	14,329,768	(3,541,805)
Net income (loss) from discontinued operations for the period (Note 4)	(1,634,672)	(3,041,466)	203,177	(1,465,059)
Net income (loss) for the period	13,222,163	(9,967,353)	14,532,945	(5,006,864)
Other comprehensive income (loss)				
Items that may be reclassified subsequently to profit or loss:				
Cumulative translation adjustment	(3,426,487)	325,026	1,744,764	586,053
Comprehensive income (loss) for the period	$ 9,795,676	$ (9,642,327)	$ 16,277,709	$ (4,420,811)
Basic and diluted income (loss) per share	$ 0.15	$ (0.11)	$ 0.17	$ (0.06)
Weighted average number of common shares outstanding	87,844,321	87,844,321	87,844,321	87,844,321

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIT)
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)

	Capital Stock		Convertible Notes – Equity Component	Stock Options Reserve	Warrants Reserve	Translation Reserve	Deficit	Total Shareholders' Equity (Deficit)
	Shares	**Amount**						
Balance – January 31, 2015	**87,844,821**	**$ 47,416,203**	**$ 2,814,173**	**$ 1,061,669**	**$ 6,099**	**$ (304,795)**	**$(36,956,082)**	**$ 14,037,267**
Effect of change in functional currency (Note 2)	-	-	-	-	-	(1,992,239)	1,280,561	(711,678)
Share-based payments	-	-	-	3,072	-	-	-	3,072
Cumulative translation adjustment	-	-	-	-	-	5,713,104	-	5,713,104
Net loss for the period	-	-	-	-	-	-	(9,967,353)	(9,967,353)
Balance – July 31, 2015	**87,844,821**	**$ 47,416,203**	**$ 2,814,173**	**$ 1,064,741**	**$ 6,099**	**$ 3,416,070**	**$(45,642,874)**	**$ 9,074,412**
Balance – January 31, 2016	**87,844,821**	**$ 47,416,203**	**$ 2,814,173**	**$ 1,034,242**	**$ 6,099**	**$ (684,574)**	**$(62,880,745)**	**$ (12,294,602)**
Expiry of options		-	-	(142,063)	-	-	142,063	-
Expiry of warrants		-	-	-	(6,099)	-	6,099	-
Changes to convertible notes		-	(785,003)	-	-		2,230,015	1,445,012
Cumulative translation adjustment	-	-	-	-	-	(3,426,487)	-	(3,426,487)
Net income for the period	-	-	-	-	-	-	13,222,163	13,222,163
Balance – July 31, 2016	**87,844,821**	**$ 47,416,203**	**$ 2,029,170**	**$ 892,179**	**$ -**	**$(4,111,061)**	**$(47,280,405)**	**$ (1,053,914)**

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
UNAUDITED – PREPARED BY MANAGEMENT
For the six months ended July 31
(Expressed in United States Dollars)

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss) from continuing operations	$ 14,856,835	$ (6,925,887)
Items not involving cash:		
Accretion of convertible notes	708,348	314,927
Depreciation and depletion	28,275	33,360
Equity loss in partnership	68,388	106,013
Share-based payments	-	3,072
Unrealized gain on foreign exchange	(2,286,150)	740,697
Gain on note extinguishment	(15,126,653)	-
Impairment of exploration and evaluation assets	-	3,031,109
Changes in non-cash working capital items:		
Accounts receivable	(23,666)	(56,941)
Prepaids	11,327	116,009
Accounts payable and accrued liabilities	854,971	(2,858,000)
Operating cash flows from continuing operations	(908,325)	(5,495,641)
Operating cash flows from discontinued operations (Note 4)	(1,228,936)	1,086,862
Net cash used in operating activities	(2,137,261)	(4,408,779)
CASH FLOWS FROM INVESTING ACTIVITIES		
Exploration and evaluation expenditures	(9,575)	-
Investment in partnership	-	(1,500,000)
Investing cash flows from continuing operations	(9,575)	(1,500,000)
Investing cash flows from discontinued operations (Note 4)	(83,076)	(10,080,139)
Net cash used in investing activities	(92,651)	(11,580,139)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net cash used in financing activities from discontinued operations (Note 4)	(2,726,768)	(70,302)
Foreign exchange effect on cash	-	-
Change in cash for the period	(4,956,680)	(16,059,220)
Cash, beginning of the period	6,340,591	26,494,024
Cash, end of the period	$ 1,383,911	$ 10,434,804

Supplemental cash flow information (Note 18)

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

1. NATURE OF OPERATIONS AND GOING CONCERN

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 for and developing conventional onshore oil and gas properties in the United States.

The Company's head office is located at Suite 270 – 666 Burrard Street, Vancouver, British Columbia, Canada V6C 2X8. The registered and records office is located at Suite 1000 – 595 Howe Street, Vancouver, British Columbia, Canada V6C 2T5.

The Company is classified as a "Tier 2 Oil and Gas Issuer", as those terms are defined in TSX Venture Exchange (the "Exchange") policies. Its common shares trade on the Exchange under the symbol "TZR".

For the six months ended July 31, 2016, the Company reported net income from continuing operations of $14.9 million, however that included a non-cash gain on note extinguishment of $15.1 million and a non-cash foreign exchange gain of $2.3 million. As of July 31, 2016, the Company had working capital of $1.0 million. Due to non-compliance with certain covenants under the Terrace STS, LLC secured credit agreement as of January 31, 2016 and the resulting default asserted by the lender during February 2016. During May 2016 the lender exchanged the debt for 95% of the equity in the subsidiary that held the debt obligation (see Note 8). Subsequent to the exchange, the Company has no cash flows from oil and gas operations unless it receives a distribution from the five percent interest retained in Terrace STS, LLC or from the BlackBrush Terrace LP interest it holds. Additionally, the Company had negative cash flow from its continuing operating activities for the six months ended July 31, 2016 and the prior fiscal year. 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 Commitments described in Note 15). 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 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.

These condensed consolidated interim financial statements have been prepared on a going concern basis, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. Management believes that the going concern assumption is appropriate for these condensed consolidated interim financial statements since management continues to seek and evaluate strategic alternatives and financial options to enable the Company to meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. These condensed consolidated interim financial statements do not include adjustments to amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue operations.

2. BASIS OF PRESENTATION

Statement of compliance

These unaudited condensed consolidated interim financial statements, including comparatives, have been prepared using accounting policies consistent with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB") and in accordance with International Accounting Standards ("IAS") 34 *Interim Financial Reporting*. The accounting policies used in the preparation of these condensed consolidated interim financial statements are the same as those applied in the Company's most recent consolidated annual financial statements for the year ended January 31, 2016. These condensed consolidated interim financial statements should be read in conjunction with the Company's consolidated annual financial statements for the year ended January 31, 2016. The policies applied in these condensed consolidated interim financial statements are based on IFRS issued and outstanding as of July 31, 2016.

2. BASIS OF PRESENTATION (Continued)

Statement of compliance (Continued)

The Board of Directors approved the unaudited condensed consolidated interim financial statements on September 29, 2016.

Basis of measurement

These condensed consolidated interim financial statements have been prepared on a historical cost basis, except for certain financial instruments, which are measured at fair value. In addition, these condensed consolidated interim financial statements have been prepared using the accrual basis of accounting, except for cash flow information.

Functional and presentation currency

The functional currency of the Company is the Canadian dollar ("CAD"), as it is presently reliant upon the Canadian capital markets to fund its activities. The functional currencies of the Company's foreign subsidiaries are the CAD and the United States dollar ("USD"). The Company changed the functional currency of certain subsidiaries from CAD to USD with effect from February 1, 2015. The change in functional currency arose due to changing sources of recent and expected future sources of financing. The change in functional currency was applied prospectively. The assets, liabilities and equity of the subsidiaries were translated from CAD to USD at the exchange rate on the date of change in functional currency. The resulting exchange differences were recognized in other comprehensive loss. These condensed consolidated interim financial statements are presented in USD, as substantially all of the Company's assets and operations are situated in the USA. Assets and liabilities are translated into the presentation currency using the exchange rate in effect on the consolidated statement of financial position date, shareholders' equity accounts are translated into the presentation currency using the historical exchange rate, and revenues and expenses are translated at the average rate for the period, which approximates the exchange rate in effect on the transaction date. Exchange gains and losses on translation are included as a separate component in shareholders' equity as "translation reserve".

3. SIGNIFICANT ACCOUNTING POLICIES

Use of judgments and estimates

The preparation of 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.

Reserves

The estimate of oil and natural gas reserves is integral to the calculation of the amount of depletion charged to the consolidated statements of operations and comprehensive income (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.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Identification of cash-generating units ("CGUs")

The Company's assets are aggregated into CGUs for the purpose of calculating impairment. 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 monitors operations.

Recoverability of asset carrying values

At each reporting date, the Company assesses its petroleum and natural gas properties and exploration and evaluation assets for possible impairment, to determine if there is any indication that the carrying amounts of the assets may not be recoverable. An assessment is also made at each reporting date to determine whether there is an indication that previously recognized impairment losses no longer exist or have decreased. Determination as to whether and how much an asset is impaired, or no longer impaired, involves management estimates on highly uncertain matters, such as future commodity prices, discount rates, production profiles, operating costs, future capital costs and reserves.

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.

Classification of exploration and evaluation assets

The application of the Company’s accounting policy for exploration and evaluation assets requires management to make certain judgments as to future events and circumstances and as to whether economic quantities of reserves will be found so as to assess if technical feasibility and commercial viability have been achieved.

Assets held for sale and discontinued operations

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 financial position 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.

Judgment is applied in determining whether disposal groups represent a component of the entity, the results of which should be recorded in discontinued operations in the condensed consolidated interim statements of operations and comprehensive income (loss).

Joint arrangements

Judgment is required to determine when the Company has joint control over an arrangement, which requires an assessment of the relevant activities and when the decisions in relation to those activities require unanimous consent. Judgment is also required to classify a joint arrangement. Classifying the arrangement requires the Company to assess their rights and obligations arising from the arrangement including whether the arrangement is structured through a separate vehicle, in which case, judgment is also required to assess the rights and obligations arising from the legal form of the separate vehicle, terms of the contractual arrangement and other relevant facts and circumstances. This assessment often requires significant judgment, and a different conclusion on joint control and whether the arrangement is a joint operation or a joint venture, may materially impact the accounting. Management has assessed the investment in partnership as a joint venture.

(Expressed in United States Dollars)

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Convertible debenture

In accordance with the substance of the contractual arrangement, convertible debentures are compound financial instruments which are accounted for separately by their components: a financial liability and an equity instrument.

The identification of convertible debenture components is based on interpretations of the substance of the contractual arrangement and therefore requires judgment from management. The separation of the components affects the initial recognition of the convertible debenture at issuance and the subsequent recognition of interest on the liability component. The determination of the fair value of the liability is also based on a number of assumptions, including contractual future cash flows, discount factors, and the presence of any derivative financial instruments.

Modification verses extinguishment of convertible debenture

Judgment is required in applying IAS 39 Financial Instruments: Recognition and Measurement to determine whether the amended terms of the loan agreements are a substantial modification of an existing financial liability and whether it should be accounted for as an extinguishment of the original financial liability.

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.

Going concern

The assessment of the Company's ability to continue as a going concern and to raise sufficient funds to pay its ongoing operating expenditures, meet its liabilities for the ensuing year, and to fund planned and contractual exploration programs, involves significant judgment based on historical experience and other factors, including expectation of future events that are believed to be reasonable under the circumstances.

Principles of consolidation

The condensed consolidated interim financial statements include the financial statements of the Company and its controlled subsidiaries. All intercompany transactions, balances, revenues and expenses are eliminated in full on consolidation.

Name of subsidiary	Place of Incorporation	Percentage ownership
Terrace US Holdings Inc.	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%

On May 20, 2016 the Company's ownership in Terrace STS, LLC ("Terrace STS") was reduced from 100% down to 5% (See Notes 4 and 8). Prior to that date the results of operations, cash flows and financial position were consolidated within the financial statements of Terrace Energy Corp. As of May 20, 2016 Terrace STS was deconsolidated from the financial statements of the Company.

4. DISPOSITION OF SUBSIDIARY AND DISCONTINUED OPERATIONS

During the quarter ended April 30, 2016, the Company entered into a letter of intent with its secured lender to whereby the lender to the Terrace STS, LLC entity agreed to convert its secured debt at the date of the transaction into 95% of the membership units of Terrace STS (see Note 8). On May 20, 2016, the Company completed the transaction to exchange the outstanding obligation owed to the lender into membership units of Terrace STS. Following the transaction, the Company continues to own the remaining 5% and will operate Terrace STS pursuant to a management contract as well as certain incentives whereby the Company may earn an additional interest in Terrace STS cash flows after certain financial milestones are achieved. As such, the assets and associated liabilities were reclassified to assets held for sale as of April 30, 2016.

Assets reclassified to assets held for sale as of April 30, 2016 totaled $26,741,217, including cash of $908,374. Liabilities totaling $1,317,163 consisting of accounts payable and accrued liabilities of $804,685 and decommissioning obligations of $512,478 were reclassified from accounts payable and accrued liabilities to liabilities associated with assets held for sale.

The Company eliminated debt obligations owed to the lender of $24,964,995 (net of unamortized discount and including accrued interest of $530,649) as a result of the debt to equity exchange transaction. Due to relinquishment of control of the subsidiary, the net assets of Terrace STS totaling $25,826,559 were deconsolidated from the financial statements of Terrace Energy Corp. upon completion of the transaction. The fair market value of the remaining 5% ownership in Terrace STS was determined to be $1,313,947 and recorded as long-term investment in Terrace STS within the statements of financial position. The Company recognized a gain of $519,051 on the disposition of the interest in Terrace STS.

As the cash flows related to the operations of Terrace STS, LLC as well as Terrace Cutlass LLC, which was disposed of during December 2015, are clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity, the financial performance of the two projects within these entities for the comparative period have been presented separately as discontinued operations in the condensed consolidated statements of operations and comprehensive income (loss) and statement of cash flows.

(Expressed in United States Dollars)

4. DISPOSITION OF SUBSIDIARY AND DISCONTINUED OPERATIONS (Continued)

The reported net income (loss) from the discontinued operations is comprised of the following:

	For the six months ended July 31, 2016	For the six months ended July 31, 2015	For the three months ended July 31, 2016	For the three months ended July 31, 2015
Revenue				
Oil and gas sales	$ 409,560	$ 3,847,845	$ 109,871	$ 1,911,533
Direct operating expenses				
Production and operating	581,526	1,003,330	15,542	552,872
Depreciation and depletion (Note 7)	-	3,639,361	-	1,908,672
Operating income (loss)	(171,966)	(794,846)	94,329	(550,011)
Other expenses				
Financing (Note 12)	1,869,408	1,650,774	410,203	619,300
Salaries and benefits (Note 16)	112,349	595,846	-	295,748
	1,981,757	2,246,620	410,203	915,048
Gain on disposition of Terrace STS	519,051	-	519,051	-
Net income (loss) from discontinued operations, net of tax	$ (1,634,672)	$ (3,041,466)	$ 203,177	$ (1,465,059)

The reported cash flows from the discontinued operations for the six months ended July 31, are as follows:

	2016	**2015**
Net loss from discontinued operations	$ (1,634,672)	$ (3,041,466)
Depreciation and depletion (Note 7)	-	3,639,361
Accretion of decommissioning obligations	2,566	5,378
Non-cash interest expense	1,866,842	483,589
Gain on disposition of Terrace STS	(519,051)	-
Accounts payable and accrued liabilities	(944,621)	-
Operating cash flows from discontinued operations	$ (1,228,936)	$ 1,086,862
Exploration and evaluation expenditures	$ (83,076)	$ (9,707,805)
Advances for future exploration	-	(372,334)
Investing cash flows from discontinued operations	$ (83,076)	$(10,080,139)
Financing cost	$ -	$ (70,302)
Principal repayment of Credit Facility	(1,709,820)	-
Cash associated with disposition of Terrace STS	(1,016,948)	-
Net cash used in financing activities from discontinued operations	$ (2,726,768)	$ (70,302)

5. INVESTMENT IN PARTNERSHIP

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 $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.

In addition to the previously funded $13 million up-front payment, as of July 31, 2016, the BTLP has spent approximately $40 million towards its drilling obligation to Shell Oil. During the year ended January 31, 2016, 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 not to further defer drilling operations at that point. If the carry payment is not satisfied in full by the end of 2018, then the BTLP will be required to pay $4 million in liquidated damages and the Farmout Agreement will be terminated.

During the year ended January 31, 2016, the BTLP drilled a new Eagle Ford Shale well, the Chittim #10H, which was successfully completed during July 2015. The BTLP also performed a minimal completion on one of the previously drilled Buda Limestone wells, the Chittim #4H. 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 was reduced from 50% to approximately 44%. In accordance with the provisions of the BTLP agreement, the Company is not entitled to any revenue and expense allocations or distribution of revenue proceeds from the Chittim #10H well.

(Expressed in United States Dollars)

5. INVESTMENT IN PARTNERSHIP (Continued)

The carrying value of $7,423,134 at July 31, 2016 (January 31, 2016 - $7,471,522), which includes $24,463,847 (January 31, 2016 - $24,416,840) in advances, which are capital contributions and 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 cumulative net loss of the BTLP of $17,040,713 (January 31, 2016 – $16,945,318). Revenues and expenses attributable to the sole risk operations conducted by Blackbrush totaling loss of $71,922 for the six months ended July 31, 2016 (2015 – $ nil) are excluded from income and allocated to the partner before allocations of income to the partners in accordance with their original 50%/50% ownership percentages. The Company’s share of the BTLP loss recognized during the six months ended July 31, 2016 was $68,388 (2015 - $106,013).

Summary of financial information of the BTLP

As at July 31,	**2016**	**2015**
Assets		
Cash	$ 235,201	$ 517,509
Other current assets	95,110	29,349
Property and equipment	17,082,433	43,788,508
	$ 17,412,744	$ 44,335,366
Liabilities		
Current liabilities	$ 1,216,764	$ 7,575,024
Decommissioning obligations	328,855	538,327
Deferred income tax liability	-	188,276
	$ 1,545,619	$ 8,301,627

For the six months ended July 31,	**2016**	**2015**
Revenue	$ 228,101	$ 71,952
Direct operating costs		
Production and operating	155,691	114,888
Depreciation and depletion	193,207	65,920
Operating loss	(120,797)	(108,856)
Other expenses	87,900	103,139
Net loss and comprehensive loss for the period	$ (208,697)	$ (211,995)

(Expressed in United States Dollars)

6. EXPLORATION AND EVALUATION ASSETS

	Big Wells	STS Olmos	STS South Expansion	Total
Balance - January 31, 2015	**$ 1,361,439**	**$ 2,606,544**	**$ -**	**$ 3,967,983**
Acquisition costs	-	-	1,427,228	1,427,228
Exploration and evaluation	594,185	8,519,256	-	9,113,441
Transfer to property and equipment	-	(8,771,614)	-	(8,771,614)
Expenditures during the year	594,185	(252,358)	1,427,228	1,769,055
Impairment charge	(3,040,953)	-	-	(3,040,953)
Effect of changes in foreign exchange rates	1,085,329	-	(86,116)	999,213
	(1,955,624)	-	(86,116)	(2,041,740)
Balance - January 31, 2016	**-**	**2,354,186**	**1,341,112**	**3,695,298**
Acquisition costs	-	-	9,575	9,575
Exploration and evaluation	-	83,076	-	83,076
Expenditures during the period	-	83,076	9,575	92,651
Transfer to assets held for sale	-	(2,437,262)	-	(2,437,262)
Effect of changes in foreign exchange rates	-	-	88,008	88,008
	-	(2,437,262)	88,008	(2,349,254)
Balance – July, 31 2016	**$ -**	**$ -**	**$ 1,438,695**	**$ 1,438,695**

Exploration and evaluation assets consist of the Company's exploration activities, which are pending the determination of economic quantities of commercially producible proven reserves. A review of each exploration project by area is carried out at each reporting date to ascertain whether economical quantities of proven reserves have been discovered and whether such costs should be transferred to depletable property and equipment components. During the period ended July 31, 2016, $Nil (2015 - $2,762,179) was reclassified to property and equipment.

During the year ended January 31, 2016, indicators of impairment existed leading to a test of recoverable amount for the Big Wells project. The Company recorded additional impairment on its Big Wells project in the amount of $594,185 related to costs incurred on the Price well, which did not result in any proved or probable reserves being assigned to the well after it was completed. Additionally, during the prior year, the Company determined it was not prudent to use its resources to drill additional wells on its Big Wells project. Accordingly, the Company forfeited its rights under the Farmout Agreement and the Company recorded impairment expense of $2,446,768 related to the seismic data it had acquired over the acreage. A value in use calculation is not applicable for this project as the Company does not have any expected cash flows from using the property at this stage of operations. In estimating the fair value less costs of disposal, management did not have observable or unobservable inputs to estimate the recoverable amount greater than $nil. As this valuation technique requires management's judgment and estimates of the recoverable amount, it is classified within Level 3 of the fair value hierarchy.

During October 2015, pursuant to an Area of Mutual Interest Agreement with a 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 south of the Company's Original STS Olmos Leases, depth limited to the Olmos Sandstone and shallower formations "STS South Expansion". 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.

(Expressed in United States Dollars)

7. PROPERTY AND EQUIPMENT

Cost	Other Equipment	Leaseholds	Oil and Gas	Total
Balance – January 31, 2015	**$ 151,750**	**$ 129,106**	**$ 23,452,411**	**$23,733,267**
Additions				
Transfer from exploration and evaluation	-	-	8,771,614	8,771,614
Change in value of decommissioning obligations	-	-	70,137	70,137
Expenditures during the year	-	-	8,841,751	8,841,751
Effect of changes in foreign exchange rates	(14,028)	(11,934)	-	(25,962)
Balance – January 31, 2016	**137,722**	**117,172**	**32,294,162**	**32,549,056**
Effect of changes in foreign exchange rates	10,021	8,526	-	18,547
Reclassified to assets held for sale (Note 4)	-	-	(32,294,162)	(32,294,162)
Balance – July 31, 2016	**$ 147,743**	**$ 125,698**	**$ -**	**$ 273,441**
Accumulated depreciation and depletion				
Balance – January 31, 2015	**$ 73,085**	**$ 33,842**	**$ 4,352,946**	**$ 4,459,873**
Charge for year	41,578	21,301	4,776,579	4,839,458
Effect of changes in foreign exchange rates	(3,657)	(4,174)	-	(7,831)
Balance – January 31, 2016	**111,006**	**50,969**	**9,129,525**	**9,291,500**
Charge for period	17,745	10,530	-	28,275
Reclassified to assets held for sale (Note 4)	-	-	(9,129,525)	(9,129,525)
Effect of changes in foreign exchange rates	8,173	3,753	-	11,926
Balance – July 31, 2016	**$ 136,924**	**$ 65,252**	**$ -**	**$ 202,176**
Net book value				
Balance – January 31, 2016	**$ 26,716**	**$ 66,203**	**$ 23,164,637**	**$ 23,257,556**
Balance – July 31, 2016	**$ 10,819**	**$ 60,446**	**$ -**	**$ 71,265**

8. CREDIT FACILITY

On June 6, 2014, Terrace STS, a wholly owned subsidiary of the Company, entered into a senior unsecured term credit facility (the “Credit Facility”), which is non-recourse to the Company, to fund the development of its STS Olmos Project in McMullen and LaSalle counties in south Texas. At inception, the aggregate amount of the Credit Facility was $75 million, of which $50 million was available to be drawn at the discretion of Terrace STS. The original term of the facility was four years with cash interest of LIBOR (with a floor of 1%) plus 7% plus accrued principal (“PIK”) interest of 5% per annum. Cash interest was to be paid monthly; principal and PIK interest were to be paid upon maturity on May 31, 2018.

During the year ended January 31, 2015, the Terrace STS made an initial draw of $25 million and received net proceeds of $24 million after deducting the agreed-upon transaction cost of $1 million. Terrace STS also incurred $1.4 million of legal and other additional costs, which have been netted against the balance outstanding under the facility and were being amortized into interest expense over the term of the credit facility.

The Company was restricted from utilizing funds drawn under the Credit Facility or funds generated from the operations of its STS Olmos Project for anything other than operating costs and ongoing development activities at the STS Olmos Project. The terms of the Credit Facility also provided for certain other covenants, including the requirement to maintain certain financial condition covenants. The financial condition covenants consisted of the quarter-end requirement to maintain an asset coverage ratio of 1.25 to 1, to maintain a current ratio of 1 to 1 and a

(Expressed in United States Dollars)

8. CREDIT FACILITY (Continued)

leverage ratio that limits the amount of debt outstanding relative to earnings before income taxes, depreciation and amortization ranging from 2 to 1 up to 3.25 to 1 depending on the period.

As at January 31, 2015, the Terrace STS was not in compliance with the asset coverage ratio and the leverage ratio pursuant to the agreement. The lender provided Terrace STS a waiver of the non-compliance at January 31, 2015 and for the expected non-compliance for the quarter ended April 30, 2015. In addition, the lender agreed to adjust the asset coverage ratio to 5.5 to 1, 4.2 to 1 and 3.6 to 1 at July 31, 2015, October 31, 2015 and January 31, 2016, respectively, and to adjust the leverage ratio requirement to 0.9 to 1, 0.9 to 1 and 0.95 to 1 at July 31, 2015, October 31, 2015 and January 31, 2016, respectively. As a condition of the waivers and reset of the covenants granted by the lender, Terrace STS agreed to increase the interest rate margin from 7% to 8% beginning June 1, 2016 and pledged the assets of Terrace STS as collateral to the Credit Facility. In addition, Terrace STS agreed to reduce the amount available to be drawn under the facility to the $25 million that is outstanding as of January 31, 2016. Terrace STS also agreed to devise a plan acceptable to the lender to enhance the overall capitalization of Terrace STS by August 31, 2015. At October 31, 2015 and at January 31, 2016, Terrace STS was not in compliance with the adjusted leverage ratio requirement. The Company and its financial advisor continued to evaluate financial options and strategic alternatives that could ultimately result in an enhanced capitalization of Terrace STS; however, the Company was unable to provide a satisfactory plan to the lender. As a result of the non-compliance of the credit agreement requirements, the lender declared a default during February 2016 and asserted default interest of 5% per annum back to the original date of non-compliance of August 31, 2015.

As a result of the default, the Company classified the Credit Facility amounts as a current liability at January 31, 2016 as it did not have an unconditional right to defer its settlement for at least twelve months from the balance sheet date, which is required to classify the debt as a non-current liability.

Terrace STS was unable to cure the default with its secured lender. The Company and the lender, as a consequence, entered into an agreement in May 2016 whereby the lender converted its secured debt, in the approximate amount of $25,453,967 (including accrued interest) at the date of the transaction into 95% of the membership units of Terrace STS. Upon closing of the conversion transaction, Terrace STS, LLC was deconsolidated from the financial statements of the Company. The Company continues to own the remaining 5% and operates Terrace STS pursuant to a management contract that provides for service fees of approximately $40,000 per month, as well as certain incentives whereby the Company may earn an additional interest in Terrace STS cash flows after certain financial milestones are achieved. Terrace STS is the owner of the Company's STS Olmos Project and NW AWP Project, which presently consists of interest in 19 gross producing wells and approximately 3,300 net undeveloped acres.

The credit facility balance converted to equity as of May 20, 2016 consisted of the following:

Balance at January 31, 2015	**$**	**23,451,243**
Financing costs incurred		(145,302)
Amortization of financing costs		808,560
PIK interest		1,328,874
Balance at January 31, 2016		**25,443,375**
Amortization of financing costs		286,316
PIK interest		414,475
Principal repayment		(1,709,820)
Balance at May 20, 2016		24,434,346
Accrued but unpaid interest at May 20, 2016		530,649
Credit Facility obligations converted into equity in Terrace STS, LLC	$	24,964,995

9. CONVERTIBLE NOTES

During 2013, the Company completed two non-brokered private placements of convertible, unsecured promissory notes in the aggregate principal amount of CAD $40,000,000. The original notes were due April 2, 2018, paid interest of 8% per annum and were convertible into 20,000,000 common shares of the Company at CAD $2.00 per share. In October 2014, the Company obtained approval for an arrangement under the *Business Corporations Act* (British Columbia) pursuant to which all of the issued and outstanding notes were exchanged for new 8% convertible unsecured notes of the Company due April 2, 2018 and governed by a trust indenture (the “Existing Notes”). The Existing Notes contained substantially similar economic terms as the original notes, including the same interest rate, maturity date and conversion price; however, they were listed for trading on the Exchange.

In response to the current market conditions and the financial position of the Company, the quarterly interest payment due January 31, 2016 was not paid. Under the trust indenture in place at January 31, 2016, an event of default would only occur if the Company failed to make an interest payment within the 15 day cure period provided for in the indenture, in respect of two consecutive interest payment dates. As such, the Company was not in default as of January 31, 2016 for failing to make the January 31, 2016 payment. Subsequent to January 31, 2016, the Company proposed a plan of arrangement (the “Arrangement”) under the *Business Corporations Act* (British Columbia) pursuant to which all of the Existing Notes would be exchanged for new convertible secured notes of the Company (the "New Notes") due April 2, 2021 (the "Maturity Date"), which are governed by a new trust indenture.

During May 2016, the Arrangement was approved by the holders of the Existing Notes and the Supreme Court of British Columbia granted a final order approving the Arrangement. As of May 13, 2016, holders of the Existing Notes are entitled to receive $1,000 in principal amount of New Notes for each $1,000 principal amount of Existing Notes held by such noteholder. Interest owing to noteholders on the Existing Notes to the date of such exchange totaling CAD $1,619,326 was forgiven at the time of exchange. While the Existing Notes are unsecured, the New Notes are a secured obligation of the Company, guaranteed by a general security agreement against all of the Company’s assets, which includes the shares of the two United States holding companies, Terrace US Holdings LLC and Terrace Investment Holdings, Inc., but not the assets of these subsidiaries. Additionally, the New Notes are interest-free, but subject to a maturity bonus equal to 5% of the aggregate total principal amount of the New Notes payable on the Maturity Date (the "Maturity Bonus"). If the New Notes are redeemed in accordance with their terms at any time within 180 days prior to the Maturity Date, one-half of the Maturity Bonus will be payable. The Maturity Bonus will be payable, at the Company's election, in cash or through the issuance of common shares of the Company at a price equal to the volume weighted average of the Company's common shares on its principal stock exchange for the ten trading days prior to any such issuance.

The Company has the right to convert all or part of the New Notes into common shares at any time if the market price of the common shares on the Exchange trades at CAD $0.70 or higher for a period of 30 consecutive trading days. The conversion price under the New Notes is $0.50 per share, compared to $2.00 per share under the Existing Notes. Holders of the New Notes may convert all or part of the outstanding principal amount of their convertible notes at the conversion price at any time during the term of the convertible notes. As of the date of this report, CAD $38,590,000 of the New Notes are outstanding and convertible into 77,180,000 shares. Under the terms of the New Notes, the holders are no longer entitled to require the Company to redeem the convertible notes in the event of a change of control of the Company.

Due to the substantial changes in the terms and cash flows associated with the notes following the exchange for the New Notes, IAS 39 “Financial Instruments: Recognition and Measurement” requires that the exchange be accounted for as an extinguishment of the Existing Notes and the issuance at fair value of the New Notes. The Company assumed a discount rate of 20% in determining the fair value of the New Notes. A gain of $15,126,653 was recognized by the Company related to the extinguishment of the Existing Notes.

(Expressed in United States Dollars)

9. CONVERTIBLE NOTES (Continued)

At July 31, 2016, CAD $38,590,000 of notes were outstanding and at January 31, 2016, CAD $38,590,000 of notes were outstanding.

The following table reconciles the carrying amount of the Existing Notes from January 31, 2015 through July 31, 2016:

	Liability	Equity	Total
Balance, January 31, 2015	**$ 27,844,656**	**$ 2,814,173**	**$ 30,658,829**
Accretion of discount	653,390	-	653,390
Effect of changes in foreign exchange rates	(2,622,631)	-	(2,622,631)
Balance, January 31, 2016	**25,875,415**	**2,814,173**	**28,689,588**
Accretion of discount	201,814	-	201,814
Effect of changes in foreign exchange rates	(1,130,801)	-	(1,130,801)
Debt extinguishment	(24,946,428)	(2,814,173)	(27,760,601)
Balance, May 13, 2016	**$ -**	**$ -**	**$ -**

The following table reconciles the carrying amount of the New Notes from May 13, 2016 through July 31, 2016:

	Liability	Equity	Total
Issuance of New Notes on May 13, 2016	$ 11,769,496	$ 2,029,170	$ 13,798,666
Accretion of discount	514,344	-	514,344
Effect of changes in foreign exchange rates	2,088	-	2,088
Balance, July 31, 2016	**$ 12,285,928**	**$ 2,029,170**	**$ 14,315,098**

(Expressed in United States Dollars)

10. DECOMMISSIONING OBLIGATIONS

The Company's decommissioning obligations result from its ownership interest in oil and gas assets, including well sites and gathering systems. The total decommissioning obligation is estimated based on the Company's ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities, and the estimated timing of the costs to be incurred in future years.

Balance, January 31, 2015	**$ 474,257**
Change in value of decommissioning obligations	70,137
Accretion expense	10,040
Settled obligations	(73,596)
Effect of changes in foreign exchange rates	10,665
Balance, January 31, 2016	**491,503**
Accretion expense	2,566
Settled obligations	(1,718)
Effect of changes in foreign exchange rates	20,127
Reclassified to assets held for sale (Note 4)	(512,478)
Balance, July 31, 2016	**$ -**

11. CAPITAL STOCK

The Company has unlimited authorized common shares without par value. At July 31, 2016, the Company has 87,844,321 (January 31, 2016 - 87,844,321) shares outstanding.

Share issues

During the periods ended July 31, 2016 and July 31, 2015, the Company did not issue any common shares.

Restricted share units

The Company has a restricted share unit plan (the "RSU Plan") that permits the issuance of an aggregate of 3,682,182 RSUs to eligible participants, as described in the RSU Plan. RSUs do not confer on the holder any right to vote at a meeting of the shareholders of the Company. Common shares reserved for issuance under outstanding RSUs must be included in the calculation of common shares remaining available for reservation pursuant to options granted under the 10% rolling option plan. The number of common shares reserved for issuance, together with any other compensation arrangements, to any one person in any twelve-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 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.

As at July 31, 2016, the Company has 1,100,000 (January 31, 2015 – 1,200,000) RSUs outstanding with a grant date fair value of CAD $2,742,208 based on the stock prices at the time of grant. 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.

(Expressed in United States Dollars)

11. CAPITAL STOCK (Continued)

Restricted share units (Continued)

The Company recognizes compensation expense for the expected number of RSUs expected to vest over the vesting period. As of July 31, 2016, there are no contemplated transactions that would give rise to vesting; therefore, no compensation expense has been recognized.

Convertible notes

As at July 31, 2016 the Company had issued and outstanding convertible notes with a face value of CAD $38,590,000 (January 31, 2016 – CAD $38,590,000) convertible into 77,180,000 common shares (Note 9).

Stock options

The Company has an incentive stock option 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, grant to directors, officers, employees and technical consultants of the Company, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. The number of common shares reserved for issuance pursuant to options granted to all technical consultants will not exceed 2% of the issued and outstanding common shares. The number of options granted to any one person cannot exceed 5% of the issued and outstanding common shares. Such options may be exercisable for a period of up to ten years from the date of grant. Vesting terms vary and will be determined at the time of grant by the Board of Directors.

Share-based payments

The Company uses a Black-Scholes method of accounting to fair value the share-based payments arising from the grant of stock options. Under this method, the Company recorded share-based payments expense of $nil for the period ended July 31, 2016 (2015 - $3,072) with a corresponding credit to reserves. These amounts represent the value of options vested during the period.

Stock option transactions and the number of stock options outstanding as at July 31, 2016 are summarized as follows:

Number of Options	Number of Options Exercisable	Exercise Price (CAD)	Expiry Date	Weighted Average Remaining Contractual Life (Years)
250,000	250,000	$ 0.21	September 16, 2016	0.10
250,000	250,000	$ 0.19	October 18, 2016	0.22
250,000	250,000	$ 0.67	December 16, 2016	0.38
150,000	150,000	$ 1.35	July 8, 2017	0.94
900,000	900,000			0.35

The weighted average exercise price of the outstanding stock options at July 31, 2016 is CAD $0.52 (2015 - CAD $0.26). There have been no stock options granted during the period ended July 31, 2016 and the year ended January 31, 2016. There were 100,000 (2015 - Nil) options with an exercise price of CAD $0.53 that expired during the year ended January 31, 2016, and 1,900,000 (2015 – Nil) options with an average exercise price of CAD $0.13 that expired during the period ended July 31, 2016.

(Expressed in United States Dollars)

11. CAPITAL STOCK (Continued)

Outstanding stock options and warrants

At July 31, 2016 there were no warrants outstanding. At January 31, 2016 there were 500,000 warrants with an exercise price of CAD $0.18 outstanding that expired during the period ended July 31, 2016.

12. FINANCING EXPENSES

	Six months ended July 31, 2016	2015
Continuing Operations:		
Interest expense	$ 641,683	$ 1,238,613
Accretion of convertible notes	708,348	314,927
Total financing expense from continuing operations	1,350,031	1,553,540
Discontinued Operations:		
Interest expense	1,166,051	1,161,807
Accretion of decommissioning obligations	2,566	5,378
Amortization of financing costs	286,316	(166,996)
PIK interest	414,475	650,585
Total financing expense from discontinued operations	1,869,408	1,650,774
Total	$ 3,219,439	$ 3,204,314

13. 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, credit facility and convertible notes – as other financial liabilities.

The Company has made the following designations of its financial instruments:

Investment in Terrace STS	Available-for-sale financial assets

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

Fair value

The carrying values of cash, accounts receivable and accounts payable and accrued liabilities approximate their fair values due to the short-term maturity of these financial instruments. The fair value of the operator's bond also approximates its carrying value.

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

(Expressed in United States Dollars)

13. FINANCIAL INSTRUMENTS (Continued)

Credit risk (Continued)

Company regularly reviews the collectability of accounts receivable to ensure there is no indication that these amounts will not be fully recoverable. The Company has no balances past due or impaired.

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 is exposed to interest rate risk on its credit facility whereby interest is based on LIBOR and its convertible notes which have a fixed interest rate.

(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 functional currency is CAD and its subsidiaries functional currencies are CAD and USD. Transactions relating to its oil and gas properties are in USD. Therefore, the Company is impacted by changes in the exchange rate between the Canadian and US dollars.

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

	July 31, 2016 (USD)	January 31, 2016 (USD)
Cash	$ 1,214,531	$ 2,075,512
Accounts receivable	-	6,800
Operator's bond	25,000	25,000
Accounts payable and accrued liabilities	(20,054)	(8,167)
Net	$ 1,219,477	$ 2,099,145

Based on the above net exposure as at, a 5% change in the Canadian/US exchange rate would impact the Company's net income (loss) and comprehensive income (loss) by approximately $60,974 (January 31, 2016 - $104,957). The assets and liabilities with exposure to foreign currency risk are those which are denominated in a different currency than the currency determined to 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.

(Expressed in United States Dollars)

13. FINANCIAL INSTRUMENTS (Continued)

Equity price risk

Equity price risk is the uncertainty associated with the valuation of assets arising from changes in equity markets. The Company's available-for-sale investments are exposed to equity price risk due to the potentially volatile and speculative nature of the businesses in which the available-for-sale investments are held. The membership units held in Terrace STS are monitored by management with decisions on sale taken at Board level. A 10% decrease in fair value of the shares would result in a $131,395 decrease in equity.

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. During the period ended July 31, 2016, the amounts outstanding under the credit facility were converted into equity which the previous lender now holds (see Note 8) and accordingly, as of the date of this report the 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 January 31, 2016 have been exchanged for new notes in the face amount of CAD $38,590,000 that do not pay interest and are due on April 2, 2021. The $1,240,293 of accrued interest related to the notes at May 13, 2016 was forgiven at the time of the transaction.

As at July 31, 2016, the Company had cash of $1,383,911, accounts receivable of $93,584, prepaids of $47,113 and current liabilities of $564,635. Current liabilities of $64,635 are due within three months of July 31, 2016.

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 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 development and there is no assurance such capital could be obtained.

Classification of financial instruments

The following table sets forth the Company's financial assets and financial liabilities measured at fair value by level within the fair value hierarchy as at July 31, 2016.

	Level 1	Level 2	Level 3
Cash	$ 1,383,911	$ -	$ -
Convertible notes	(614,792)	-	-
	$ 769,119	$ -	$ -

The following table sets forth the Company's financial assets and financial liabilities measured at fair value by level within the fair value hierarchy as at January 31, 2016.

	Level 1	Level 2	Level 3
Cash	$ 6,340,591	$ -	$ -
Credit facility	-	-	(26,939,154)
Convertible notes	(13,776,239)	-	-
	$ (7,435,648)	$ -	$ (26,939,154)

14. CAPITAL DISCLOSURES

The Company considers its capital under management to be shareholders' equity, convertible notes and the Credit Facility. The Company's capital management objectives are to ensure the Company continues as a going concern, as well as to maintain optimal returns to shareholders and benefits for other stakeholders. The Board of Directors does not establish quantitative criteria for management, but rather relies on management expertise to sustain future development. Management will adjust the capital structure as necessary to achieve the objectives.

The Company's capital management strategy has not changed from January 31, 2016; however, effective May 20, 2016, the Company is no longer subject to the capital requirements imposed by the former lender (see Note 8).

15. COMMITMENTS AND CONTINGENCIES

The Company has a commitment to make monthly rental payments pursuant to an office rental agreement in Vancouver, British Columbia, which commenced July 1, 2013 for a term of seven years. The lease requires total annual payments of CAD $72,511 in years three, four and five, and CAD $76,198 in years six and seven. In December 2015, the Company entered into a sublease of the office space commencing February 1, 2016 through the remaining term of the lease for CAD $58,992 per year.

The Company has a commitment to make monthly rental payments pursuant to an office rental agreement in Houston, Texas, through October 31, 2017. The lease requires total annual payments of $71,775 and $56,700 for the twelve months ended January 31, 2017 and the final nine months on the lease, respectively.

Total rent expense net of sublease payments included in the condensed consolidated statements of operations and comprehensive income (loss) for the six months ended July 31, 2016 amounted to $35,250 (2015 - $54,841).

At July 31, 2016 the Company had convertible notes outstanding that have been exchanged for New Notes in the face amount of CAD $38,590,000 that do not pay interest and are due on April 2, 2021 (Note 9).

The Company has interests in certain exploration and evaluation assets, which are subject to certain expenditure commitments (Notes 6 and 7).

During the year ended January 31, 2015, the Company acquired non-proprietary 3-D seismic data over its Big Wells project at a cost of approximately $2.3 million as part of a multi-year commitment to purchase additional 3-D seismic data at a volume discounted value of approximately $4.7 million over the next two years. The additional data was 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.

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 judgment against the wholly owned subsidiary. Accordingly the Company has recorded a provision in the amount of the asserted liquidated damages of $500,000. The Company will continue to vigorously defend its position. The Company believes this suit to be without merit and has appealed the court ruling including a counter-claim against the farmor for damages relating to breach of contract.

(Expressed in United States Dollars)

16. RELATED PARTY TRANSACTIONS

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

	Six months ended July 31,	
	2016	**2015**
Short-term compensation	$ 506,334	$ 720,909
Share-based payments	-	1,536
Recoveries	(334,295)	-
	$ 172,039	$ 722,445

Included in accounts payable and accrued liabilities as at January 31, 2016 are amounts payable to key management personnel totalling $5,029 (January 31, 2016 - $5,235).

At July 31, 2016, convertible notes held by key management personnel and their close family members totalled CAD $3,230,000 (January 31, 2016 - CAD $3,230,000). Interest paid on these convertible notes totalled $nil during the period (2015 - CAD $128,138).

All related party amounts included in accounts receivable and accounts payable and accrued liabilities are due on demand.

17. SEGMENTED INFORMATION

The Company has one operating segment, which is the acquisition, exploration and development of oil and gas properties. Geographic segmentation of the Company's non-current assets is as follows:

	July 31, 2016		
	USA	**Canada**	**Total**
Exploration and evaluation assets	$ 1,438,695	$ -	$ 1,438,695
Property and equipment	5,277	65,988	71,265
Investment in partnership	7,423,134	-	7,423,134
Investment in Terrace STS	1,313,947	-	1,313,947
	$ 10,181,053	$ 65,988	$ 10,247,041

	January 31, 2016		
	USA	**Canada**	**Total**
Exploration and evaluation assets	$ 3,695,298	$ -	$ 3,695,298
Property and equipment	23,171,811	85,745	23,257,556
Investment in partnership	7,471,522	-	7,471,522
	$ 34,338,631	$ 85,745	$ 34,424,376

Exploration and development activities and producing properties are located in the US and oil and gas revenues are derived from US operations.

18. SUPPLEMENTAL CASH FLOW INFORMATION

During the period ended July 31, 2016, the Company:

a) transferred assets totaling $26,741,217 consisting of cash of $908,374, accounts receivable of $220,300, prepaids of $10,641 and exploration and evaluation and property and equipment of $25,601,899 to assets held for sale and transferred liabilities totaling $1,317,163 consisting of accounts payable and accrued liabilities of $804,685 and decommissioning obligations of $512,478 to liabilities associated with assets held for sale at April 30, 2016;

b) converted Credit Facility principal and interest of $24,964,995 into equity in the Terrace STS, LLC entity on May 20, 2016 and as a result deconsolidated the assets which were included in assets held for sale at the time of the transaction totaling $26,860,101 and the liabilities associated with the assets held for sale totaling $1,033,542 (See Note 4).

During the period ended July 31, 2015, the Company:

a) transferred $6,274,850 from exploration and evaluation assets to property and equipment;

b) had accounts payable and accrued liabilities of $611,839 related to exploration and evaluation expenditures; and

c) paid $2,323,766 of interest, received $nil of interest and paid $nil income taxes.