

# THIRD QUARTER INTERIM REPORT

For the three and nine month periods ended September 30, 2016

## **MESSAGE TO SHAREHOLDERS**

The third quarter was a period of focus to optimize the Company's cashflow, following the financial recapitalization completed during the second quarter and the recent changes to the organisation.

Previously, the Company reported the completion of a major recapitalization of the Company and its subsidiaries, which resulted in a reduction in debt to more appropriate levels and access to a new Super Senior Revolving Credit Facility ("SSRCF"). As of September 30, 2016, the balance of the SSRCF was zero and from the closing of the recapitalization on May 30, 2016 through to the date of this report the SSRCF has not been utilized.

The Company has implemented further cost reduction initiatives, with a stated objective of minimizing cost expenditures to maximize net cash flows from the UK Breagh gas field. Subsequent to the closure of the London office, David Blewden departed the Company at the end of August 2016. Christine Shinnie has been appointed to the position of Chief Financial Officer. Sterling has completed its workforce reduction program in the third quarter, resulting in total staff reductions since the end of 2015 of 53 percent. Included in the cost reduction initiative was the commitment to lower general and administrative costs (excluding costs associated with the now-completed strategic review and recapitalization) to approximately US\$4 million on a full year gross basis going forward (before allocations and recoveries).

On the operational front, the Company's focus has been on the UK Breagh gas field. Breagh continues to maintain a solid production history with an average uptime in 2016 to-date of 92 percent and average daily gas sales of 73 million standard cubic feet per day ("MMscf/d") gross, net 21.9 MMscf/d to Sterling. We continue to maintain our target production for 2016 at 71 MMscf/d for 100 percent of the field (21.3 MMscf/d net) for Breagh. All outstanding works at the Teesside Gas Processing Plant have now been completed and the Breagh partnership has entered into an Amended and Restated Gas Processing and Operations Agreement. In addition, the Company has entered into a new Gas Sales Agreement with British Gas Trading Limited, a subsidiary of Centrica plc. The agreement provides for the Company's share of Breagh gas volumes to be sold on a day ahead basis at the UK reference price at the National Balancing Point.

Breagh average realized gas price was \$4.14 per thousand standard cubic feet ("Mscf") in the third quarter. This is \$0.31 per Mscf lower compared to the second quarter of 2016. Average realized price for gas sold in October 2016 was US\$5.05 per Mscf.

Looking forward on the Breagh field, the Company is preparing for major new investment for the field, with our expectation of returning to drilling on the Breagh Alpha platform during second quarter 2017 and sanctioning the compression project in the second quarter of 2017. The interpretation of 3D seismic and preliminary subsurface evaluations of the proposed A09 and A10 wells have now been completed. Following-on from this work on the new well locations, an evaluation of the Phase 2 development in the southeastern portion is expected to be completed during 2017.

On the Cladhan Field, production averaged 5,950 barrels per day ("bbl/d") gross during the third quarter (119 bbl/day net to the Company). Full year average production is forecast to be 6,620 bbl/d gross (132 bbl/day net to the Company) for 2016.

In summary for the third quarter, production from the Breagh field has been in-line with our forecast resulting in the Company maintaining a cash balance in excess of requirements. With gas prices continuing to improve during November and forecast to remain or improve on current prices during the first quarter of 2017, together with the bulk of the capital expenditure anticipated to occur during second quarter 2017, the Company expects to continue to build our cash balance prior to commencing the well and compression projects during 2017.

We look forward to what will be a very active year in 2017.

On Behalf of the Board of Directors,

John Rapach

Chief Executive Officer and Chief Operating Officer

November 22, 2016

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") of the operating results and financial condition of Sterling Resources Ltd. ("Sterling" or the "Company") for the three and nine month periods ended September 30, 2016 is dated November 22, 2016, and should be read in conjunction with Sterling's unaudited condensed interim consolidated financial statements for the three and nine month periods ended September 30, 2016 as well as Sterling's audited consolidated financial statements for the year ended December 31, 2015 which have been prepared in accordance with IAS 34 Interim Financial Reporting, and International Financial Reporting Standards ("IFRS"), respectively.

Financial figures throughout this MD&A are stated in United States dollars (\$) unless otherwise indicated.

#### CORPORATE OVERVIEW AND STRATEGY

Sterling is a publicly-traded, international energy company currently engaged in the exploration for, and the development and production of, crude oil and natural gas. The Company operates primarily in the United Kingdom and the Netherlands, has exited Romania and is seeking to exit France. It is domiciled in Calgary, Alberta.

The Company's primary strategy is to focus on the efficient development of the UK Breagh gas field and to exit or materially reduce exposure to exploration, appraisal and early stage development assets that cannot easily be financed. In practice, this means focusing on the UK North Sea. Opportunities for a corporate merger or sale will be considered where this can lead to a superior return for shareholders.

#### FORWARD-LOOKING STATEMENTS AND BUSINESS RISKS

Certain statements in this MD&A are forward-looking statements. These statements relate to future events or the Company's future performance. All statements other than statements of historical fact may be forward-looking statements. In some cases, forward-looking statements can be identified by terminology such as "may", "will", "would", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue", "intend", "target", "outlook", "goal", "project", "can", "shall", "is designed to", "with the intent", "strategy" or the negative of these terms or other comparable terminology. In addition, statements relating to reserves or resources are deemed to be forward-looking statements as they involve the implied assessment, based on certain estimates and assumptions that the reserves and resources described can be profitably produced in future.

These statements are only predictions. Actual events or results may differ materially. In addition, this MD&A may contain forward-looking statements attributed to third-party industry sources which are not endorsed or adopted by Sterling expressly or implicitly. Undue reliance should not be placed on these forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By their nature, forward-looking statements involve 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 statements will prove inaccurate. Forward-looking statements in this MD&A include, but are not limited to, statements with respect to:

- Expectations for gas prices, and together with other factors including the timing and amount of capital expenditures during 2017, their impact on the Company's cash balances;
- The focus, timing and amount of capital expenditures;
- Expectations for the cost of decommissioning obligations on the Breagh development;
- Future debt levels and annual interest costs;
- Capital expenditure programs, including without limitation the timing of, the sources of capital and expenses related to, and
  the nature of, the further development of the Breagh field, including with respect to the remaining Phase 1 development
  including the timing and cost of the Company's infill drilling campaign in relation to new wells and the re-entry and hydraulic
  stimulation of existing wells, the timing, cost and implementation of onshore compression at TGPP (as defined herein) and
  the evaluation, timing, extent and cost of the potential Phase 2 development;
- Expectations that the proposed abandonment and site restoration of the Grenade-3 well in France will be formally approved;

- The interpretation of seismic and its role in facilitating new geographic and reservoir models and their impact on the Company's infill drilling campaign and in relation to Breagh Phase 2 development;
- Expectations that the Second Carry (as defined herein) in relation to the Cladhan field will not be repaid and hence that a
  further 11.8 percent interest in the field will not be returned to the Company and expectations as to the timing and amount
  by which the Second Carry will be reduced over time;
- Expectations regarding the Company's cost structure, including expectations as to the reduction of certain well commitments through farm-in or licence extensions and the reduction of certain lease obligations pursuant to an existing sub-lease;
- Expectations for the Company's ability to satisfy the financial covenants under the Bond Agreement (as defined herein) and
  under the SSRCF (as defined herein), the utility of the SSRCF to meet all reasonable downside scenarios of operating and
  financial performance, its anticipated usage of the SSRCF and its ability to refinance the SSRCF and the Bond (as defined
  herein) prior to the SSRCF maturity date and the manner of such refinancing;
- The viability of the Company as a going concern;
- The quantity, timing and volumes of hydrocarbon production from the Company's Breagh and Cladhan fields, including for Breagh, benefits from hydraulic stimulation performed on wells;
- The Company's ability to obtain certain government and regulatory approvals;
- The Company's cash requirements and funding for the next year;
- The Company's expectations regarding commitments, future cash flows and cash balances and its plans for mitigating risks that may affect its cash position;
- The Company's drilling plans on any of its licences;
- Tax matters, including: the Company's tax profile in each of the UK, the Netherlands and Canada; its expectations with respect to the payment of corporate tax, claiming RFES (as defined herein) and the implications on CT and SCT losses (each as defined herein); its intention to claim investment allowances as applicable in relation to the Breagh and Cladhan fields and the impact thereof to Sterling;
- The Company's strategy and the Company's plans and expectations that are described on page 22 under "2016 Plans".

With respect to forward-looking statements in this MD&A, the Company has assumed, among other things, that the Company:

- Will be able to satisfy the undertakings and conditions under the Bond Agreement, as revised pursuant to the approval of the Fourth Bond Amendments (as defined herein) and under the SSRCF;
- Will produce hydrocarbons which are consistent with the production profiles prepared by the independent reserves evaluator in the Company's NI 51-101F1 (as defined herein) filing, dated April 14, 2016, as revised by management;
- Operates in an environment of political and regulatory stability;
- Will be able to obtain all necessary partner and regulatory approvals for a particular course of action on satisfactory terms;
- Operates in an environment of increasing competition;
- Is able to continue to attract and retain qualified personnel either as staff or consultants;
- Is able to continue to obtain services and equipment in a timely manner; and
- Will be able to progress plans for future investments in Breagh and achieve expected incremental production from such future investments.

Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. The Company cannot guarantee future results, levels of activity, performance, or achievements. The risks and other factors, some of which are beyond the Company's control, which could cause results to differ materially from those expressed in the forward-looking statements contained in this MD&A include, but are not limited to:

- Reserves, resources and production estimates may prove incorrect;
- The finding, determination, evaluation, assessment and measurement of oil and gas deposits or reserves may vary materially from the estimates, plans and assumptions of the independent reserves evaluator or the Company;
- Exploration and development activities are capital-intensive and involve a high degree of risk and accordingly future appraisal of potential oil and natural gas properties may involve unprofitable efforts;
- Oil and natural gas prices fluctuate;
- Without the addition of reserves through exploration, acquisition or development activities, the Company's reserves and production will decline over time as reserves are exploited;
- Production and processing operations may prove more difficult, costly or less efficient than planned;
- All modes of transportation of hydrocarbons include inherent and significant risks;
- Interruptions in availability of exploration, production or supply infrastructure;
- The Company's majority shareholder has significant influence on the Company and may also affect the market price and liquidity of the Company's securities;
- Third party contractors and providers of capital equipment can be scarce;
- Reliance on other operators and stakeholders limits the Company's control over certain activities;
- Availability of joint venture partners and the terms of agreement between them and the Company will depend upon factors beyond the Company's control;
- Permits, approvals, authorizations, consents and licences may be difficult to obtain, sustain or renew;
- Regulatory requirements can be onerous and expensive;
- The Company cannot completely protect itself against title disputes;
- The Company is substantially dependent on its executive management;
- Environmental legislation can have an impact on the Company's operations;
- Additional funding and/or a refinancing of existing debt may not be available or may be very expensive and restrictive;
- The Company's operations are subject to the risk of litigation;
- Significant competition exists in attracting and retaining skilled personnel;
- Competition in the international oil and gas industry could limit the Company's and its partners' ability to obtain licences and key supplies, such as drilling rigs if and when required;
- Future acquisitions may involve many common acquisition risks and may not meet expectations;
- Insurance and indemnities may not be sufficient to cover the full extent of all liabilities;
- Fluctuations in foreign exchange rates, interest rates and inflation may cause financial harm to the Company;
- Political or governmental changes in legislation or policy in the countries in which the Company operates may have a negative impact on those operations;
- Labour unrest could affect the Company's ability to explore for, produce and market its oil and gas production;
- Risks related to the countries in which the Company operates;
- Uncertainties of legal and tax systems in jurisdictions in which the Company operates;
- Failure to meet contractual agreements may result in the loss of the Company's interests; and

• Failure to follow corporate and regulatory formalities may call into question the validity of the existence and conduct of the Company and its subsidiaries and their respective rights in relation to the Company's assets.

These factors should not be considered exhaustive. Readers should also carefully consider the matters discussed under "Risk Factors" beginning on page 23 of the Company's Annual Information Form for the year ended December 31, 2015, filed on the Company's SEDAR profile at <a href="https://www.sedar.com">www.sedar.com</a>.

The forward-looking statements contained in this MD&A are expressly qualified by the foregoing cautionary statement. Subject to applicable securities laws, the Company is under no duty to update any of the forward-looking statements after the date hereof or to compare such statements to actual results or changes in the Company's expectations. Financial outlook information contained in this MD&A about prospective results of operations, financial position or cash flows is based on assumptions about future events, including economic conditions and proposed courses of action, based on management's assessment of the relevant information currently available. Readers are cautioned that such financial outlook information should not be used for purposes other than for which it is disclosed herein.

## SIGNIFICANT JUDGMENTS AND ESTIMATES

Management is required to make judgments, assumptions and estimates in the application of IFRS that have a significant impact on the Company's financial results. Significant judgments in the financial statements include going concern, joint arrangements, funding arrangements, impairment indicators and determination of cash generating units. Significant estimates in the financial statements include amounts recorded for the provision for future decommissioning obligations, the Cladhan funding arrangements, embedded derivatives, commitments, income taxes and deferred tax assets, exploration and evaluation assets, capital expenditure accruals and timing of production start-up. In addition, the Company uses estimates for numerous variables in the assessment of its assets for impairment purposes, including oil and natural gas prices, exchange rates, discount rates, cost estimates and production profiles. By their nature, all of these estimates are subject to measurement uncertainty, may be beyond management's control and the effect on future consolidated financial statements from changes in such estimates could be significant and affect the going concern of the Company.

## **NON-GAAP FINANCIAL MEASURES**

This MD&A contains references to certain financial measures used by the Company that do not have a standardized meaning prescribed by GAAP and may not be comparable to similar measures presented by other entities. Readers are cautioned that these non-GAAP measures should not be construed as alternatives to other measures of financial performance calculated in accordance with GAAP. The non-GAAP measures and their manner of reconciliation to GAAP financial measures are discussed below. These non-GAAP measures provide additional information that management believes is meaningful in describing the Company's operational performance, liquidity and capacity to fund capital expenditures and other activities. The specific rationale for, and incremental information associated with, each non-GAAP measure is discussed below.

References to operating netback, funds flow from operations ("FFFO"), property, plant and equipment and exploration and evaluation asset expenditures and net working capital surplus (deficit) throughout this MD&A have the meanings as set out in this section.

Operating netback is defined as revenue less third party entitlement and operating expenses (each being a GAAP financial measure), and is used to analyze operating performance.

FFFO is defined as net income (loss) (a GAAP financial measure) less adjustments for non-cash items (see "Condensed consolidated statement of cash flows" in the Company's unaudited condensed interim consolidated financial statements for the three and nine month period ending September 30, 2016 and 2015) and is used to analyze operating performance.

Property, plant and equipment and exploration and evaluation asset expenditures is defined as expenditures on property, plant and equipment and exploration and evaluation assets including the effects of accruals (see notes 6 & 7 in the Company's unaudited condensed interim consolidated financial statements for the three and nine-month period ending Sept 30, 2016 and 2015) and is used to monitor the capital intensity of assets.

Net working capital surplus (deficit) is defined as current assets less current liabilities excluding the Cladhan funding arrangements.

# **OPERATING HIGHLIGHTS**

	9 months ending	3 m	2016 nonths endi	ng	2015 3 months ending	9 months ending	3 m	2015 nonths ending		2014 3 months ending
\$000s except where defined	Sep. 30	Sep. 30	Jun. 30	Mar. 31	Dec. 31	Sep.30	Sep.30	Jun.30	Mar. 31	Dec. 31
Average daily sales from Breagh										
production (111 ) (1)		•••	24.0	24.0	20.4	24.7	22.4	25.0	27.2	
Natural gas (MMscf/day) (1)	21.9	20.9	21.0	24.0	28.1	31.7	32.1	25.8	37.2	32
Liquids (bbl/day) (1)	63.2	66.7	50.9	72	130.1	110.1	79.1	82.7	158.6	81.6
Average Breagh realized prices										
Natural gas (\$/Mscf) (1)	4.31	4.14	4.45	4.33	5.50	6.83	6.34	6.85	7.25	8.34
Liquids (\$ per barrel) (1)	41.52	43.24	44.90	37.51	45.26	50.95	46.77	57.46	53.17	53.36
Breagh revenues	26,660	8,204	8,701	9,714	14,746	60,562	19,065	16,508	25,016	25,026
Other revenues including from hedging	40	-	40	-	238	1,280	270	215	800	863
Cladhan 2% oil sales revenues	1,600	660	540	407	-	-	-	-	-	-
Cladhan 11.8% oil sales revenues (2)	8,260	2,840	3,068	2,377	-	-	-	-	-	-
Revenues	36,560	11,704	12,349	12,498	14,984	61,842	19,335	16,723	25,816	25,889
Third party entitlement	(1,559)	(509)	(449)	(596)	(801)	(6,394)	(1,483)	(1,925)	(3,019)	(2,966)
Operating expense	(9,253)	(3,269)	(3,001)	(2,989)	(3,917)	(13,794)	(4,322)	(4,297)	(5,187)	(4,912)
Operating expense (\$) per barrel of oil equivalent	8.55	9.44	8.99	7.88	8.79	9.24	8.53	10.64	8.90	9.84
Operating netback (3)	25,748	7,926	8,899	8,913	10,266	41,654	13,530	10,501	17,610	18,011
Other expenses	(20,134)	(7,074)	4,120	(16,529)	(4,270)	(61,697)	(22,430)	(2,695)	(36,299)	(25,990)
Impairment of oil and gas properties	(17,724)	(2,739)	(13,722)	(1,593)	(28,127)	(10,158)	(9,776)	-	-	(78,419)
Net financing cost	(20,762)	(4,133)	(8,429)	(8,158)	(5,009)	(19,914)	(7,648)	(6,465)	(5,743)	(6,756)
Loss on disposal	(8)	(4)	(2)	-	(1,494)	(964)	(924)	-	(4)	-
Income tax:										
Income tax expense	-	-	-	-	-	-	-	-	-	-
Deferred tax (debit) credit	-	-	-	-	(122,020)	657	16,493	3,408	(20,103)	37,676
Net (loss) income	(32,880)	(6,024)	(9,134)	(17,367)	(150,654)	(50,422)	(10,755)	4,749	(44,539)	(55,478)
Canada	(2,626)	(1,143)	58	(1,496)	(2,029)	(4,118)	(2,427)	(758)	(869)	(1,658)
United Kingdom	(30,076)	(4,853)	(9,190)	(15,728)	(148,552)	(42,790)	(8,541)	7,185	(41,540)	(9,000)
Romania (4)	_	-	-	-	-	(2,420)	565	(1,380)	(1,686)	(44,760)
Other International	(178)	(28)	(2)	(143)	(73)	(1,094)	(352)	(298)	(444)	(60)
Net (loss) income	(32,880)	(6,024)	(9,134)	(17,367)	(150,654)	(50,422)	(10,755)	4,749	(44,539)	(55,478)
Per weighted average common share – basic and diluted (\$) (5)	(0.11)	(0.04)	(0.03)	(0.04)	(0.34)	(0.13)	(0.03)	0.01	(0.12)	(0.19)
Funds flow from operations (FFFO) (3)	8,335	605	7,602	184	4,612	20,215	3,135	10,566	6,965	25,173
FFFO per common share outstanding	0.06	0.00	0.00	0.00	0.01	0.05	0.01	0.00	0.01	0.07
Property, plant and equipment and exploration and evaluation asset										
expenditures (3)	7,258	1,065	1,691	4,502	11,183	36,696	9,433	13,025	14,238	36,230

As at	2016			2015				2014
\$000s except share information, acreage and well data	Sep.30	Jun.30	Mar.31	Dec.31	Sept.30	Jun.30	Mar.31	Dec.31
Net working capital surplus (deficit) (3)	9,882	9,925	(186,769)	(179,589)	(35,142)	(63,246)	(36,496)	(29,956)
Total assets	365,235	385,893	429,403	453,440	630,491	660,017	631,825	684,817
Total liabilities	99,817	103,825	278,243	278,667	306,055	321,253	316,042	307,715
Shareholders' equity	265,418	282,068	151,160	174,773	324,436	338,764	315,783	377,102
Net licence acreage (000s of acres) (1)	344	379	379	397	504	1,285	1,384	1,482
Number of producing wells (1)	10	10	10	10	8	8	8	8
Common shares outstanding (000s) – basic (1)	147,186	14,719,099	441,573	441,573	441,573	381,200	381,200	381,200
Common share options outstanding (000s) (1)	177	21,400	21,923	24,432	24,568	12,025	13,988	16,208

<sup>(1)</sup> Non-financial data.

<sup>(2)</sup> Cladhan 11.8% oil sales revenues relate to revenues which go to pay down the Cladhan funding arrangements – see "Financing Activities – Cladhan funding arrangements")

<sup>(3)</sup> Non-GAAP measure. See "Non-GAAP Financial Measures"

- (4) The Company's interests in Romania were sold effective August 26, 2015 see "Financing Activities Romanian Sale and Carve-out Transaction"
- (5) In the calculation of the weighted average shares outstanding for the periods the effects of the Recapitalization (as defined herein), and the Consolidation (see "Financing Activities") have been treated as occurring on the same day.

  Note: The net income or loss for each quarter is calculated using the average rates for that quarter, while the cumulative period used elsewhere in the MD&A and financial statements is calculated using the average rates for that cumulative period. Therefore, due to exchange rate fluctuations the aggregate of the quarters may differ from the cumulative period total. In addition, the net income or loss per common share for each quarter is required to be calculated independently of the calculation for the year. Consequently, due to the issuance of shares in a given year, the aggregate of the four quarters may differ from the year's total.

Between September 30, 2016 and the release of this MD&A, there was no change to the number of common shares in the capital of the Company ("Common Shares") however 63,000 stock options have expired or been cancelled during that period.

For the nine month period ended September 30, 2016, the Company recorded a net loss of \$32,880,000 (\$0.11 per weighted average Common Share (see footnote 5 above)) compared with a net loss of \$50,422,000 (\$0.13 per weighted average Common Share) for the nine month period ended September 30, 2015. The net loss in 2016 was mostly due to lower revenues, due to lower prices and production, compared to in the nine month period ended September 30, 2015.

Net (loss) income largely comprises the following elements:

#### **REVENUE**

For the three month period ended September 30, 2016, revenue was \$11,704,000 (three month period ended September 30, 2015 - \$19,335,000).

#### **BREAGH**

For the nine month period ended September 30, 2016, Breagh revenue was \$26,660,000 (nine month period ended September 30, 2015 - \$60,562,000). These revenues came from sales of gas production of approximately 6.2 billion cubic feet ("Bcf") at an average realized gas price of 30.8 pence per therm (\$4.31 per thousand cubic feet) and 2,354 tonnes of condensate (17,307 barrels) at an average price of \$305 per tonne. For the nine month period ended September 30, 2015, revenues came from sales of gas production of approximately 8.8 Bcf at an average realized gas price of 43.8 pence per therm (\$6.83 per thousand cubic feet), 3,600 tonnes of condensate (29,071 barrels) at an average price of \$425 per tonne. Up until September 30, 2016 the Company sold its gas under a Gas Trading and Services Agreement ("GTSA") with Vitol SA ("Vitol") signed in 2011 whereby Sterling nominated volumes on a day ahead or month ahead basis and achieved a price very close to the UK reference spot price at the National Balancing Point ("NBP"). When Sterling nominated gas to Vitol, it must deliver such a volume and Vitol must take and pay for this volume. The GTSA provided for payment to Sterling for over-deliveries, and a charge for under-deliveries, on normal market terms. Sterling was paid by Vitol in the month following production and one hundred percent of these revenues were derived from one customer and one contract.

On September 8, 2016, the Company announced that it had entered into a gas sales agreement with British Gas Trading Limited ("BGT"), a subsidiary of Centrica plc. The agreement provides for Sterling's share of Breagh nominated gas volumes to be sold on a day ahead basis to the UK reference price at the NBP. Under the contract Sterling delivers the Company's share of Breagh gas to BGT on a day ahead basis, and BGT must take and pay for this volume. The gas sales agreement incorporates arrangements for payment to Sterling for over-deliveries, and recovery of incremental costs incurred by BGT for under-deliveries, on normal market terms. The agreement is valid for a minimum two year period with gas made available to BGT commencing October 1, 2016. The agreement replaces the GTSA with Vitol which expired on October 1, 2016. Sterling is paid by BGT in the month following production.

The Breagh field produces a small amount of condensate (the condensate-gas ratio is approximately 3.1 barrels per million standard cubic feet) ("MMscf") which is sold to Petrochem Carless Ltd at a price linked to North West European spot prices for naphtha and other products, with cargoes typically being sold every one to three months. One hundred percent of these revenues are derived from one customer and one contract.

## **CLADHAN**

First sales from the Cladhan oil development occurred in the first quarter of 2016. During the nine month period ended September 30, 2016, sales relating to the Company's 2 percent equity interest totalled \$1,600,000 which came from the sale of 38,300 barrels of oil equivalent ("boe") at an average realized price of \$42 per boe.

During the nine month period ended September 30, 2016, the Company also recognized \$8,260,000 of Cladhan revenues relating to sales of oil on the 11.8 per cent of the Cladhan development which is being funded by TAQA Bratani ("TAQA") (see "Financing Activities - Cladhan funding arrangements") for which no cash was received as the amount was withheld by TAQA to reduce the amounts it had previously paid on the Company's behalf under the carry arrangement.

While production on the Cladhan development commenced in mid-December 2015, no oil was sold and no revenues were recorded in the year ended December 31, 2015.

#### THIRD PARTY ENTITLEMENT

For the three and nine month periods ended September 30, 2016, a third party entitlement of \$509,000 (three month period ended September 30, 2015 - \$1,483,000) and \$1,559,000 (nine month period ended September 30, 2015 - \$6,394,000), was charged to the income statement respectively. The current year amounts were lower due to a reduction to the rate of the entitlement payments from 12.23 percent to 6.10 percent late in 2015 and is commensurate with lower production revenues. This amount was recorded pursuant to a funding agreement originally signed with Gemini Oil & Gas Fund II, L.P ("Gemini") in 2007, which provided payments linked to any future production revenues from the Breagh field (which at the time had not been determined to be commercial). Cumulative costs from the fourth quarter of 2013 (during which period first production occurred) to September 30, 2016 amount to \$17,779,000.

The original Gemini funding agreement related to the funding of an appraisal well on the Breagh field, and was amended to provide funding for an additional appraisal well in 2008 and was amended again in 2009 when Sterling sold one third of its Breagh interest to RWE Dea UK ("RWE") and made a payment to Gemini to reduce the future entitlement payments by one third (the "2009 Reduction"). The stream of future entitlement payments was purchased by FlowStream Commodities Ltd ("FlowStream") with effect from July 1, 2014. Under the funding agreement, FlowStream is entitled to payments calculated with reference to a share of gas and condensate production revenue from Breagh. This share is equal to 12.23 percent of Sterling's 30 percent revenue until cumulative payments exceed twice the funding amount of \$7,333,000 (net of adjustment for the 2009 Reduction), then 6.10 percent up to three times the funding amount, and 2.77 percent thereafter until a defined percentage (currently 85 percent) of the field's ultimate reserves have been produced. This percentage is itself dependent on the ultimate reserves for the whole field, being 95 percent for reserves of up to 300 Bcf, 90 percent for reserves of 300 Bcf to less than 400 Bcf, 85 percent for reserves of 400 to less than 500 Bcf, and 80 percent for reserves of 500 Bcf or more. In the absence of production, there is no obligation to repay the funding amount. The funding arrangement has been accounted for as a reduction in the carrying value of the Breagh asset on the Company's balance sheet. Entitlement payments under the funding agreement are not deductible for UK ring fence corporation tax ("CT") or supplementary charge corporate tax ("SCT'). During the fourth quarter of 2015, entitlement payments were reduced from the highest rate of 12.23 percent to 6.10 percent as a result of cumulative entitlement payments exceeding twice the funding amount.

# **OPERATING EXPENSES**

For the three month period ended September 30, 2016, operating expenses were \$3,269,000 (three month period ended September 30, 2015 - \$4,322,000). For the nine month period ended September 30, 2016, operating expenses were \$9,253,000 (nine month period ended September 30, 2015 - \$13,794,000). Operating expenses relate to fixed and variable costs at the Breagh field and onshore gas processing plant costs, including allocations of certain Sterling costs and since December 15, 2015, operating expenses on the Company's interest on the Cladhan field. These costs are down from the previous year reflecting lower production volumes from the Breagh field partly offset by Cladhan operating expenses.

# DEPLETION, DEPRECIATION AND AMORTIZATION (DD&A)

For the three month period ended September 30, 2016, depletion of \$6,840,000 (three month period ended September 30, 2015 – \$6,940,000) on the Breagh and Cladhan assets and depreciation of \$35,000 (three month period ended September 30, 2015 – \$19,000) on corporate and other assets was charged to the income statement. For the nine month period ended September 30, 2016 depletion of \$25,922,000 (nine month period ended September 30, 2015 – \$26,440,000) on the Breagh asset and depreciation of \$70,000 (nine month period ended September 30, 2015 – \$82,000) on corporate and other assets was charged to the income statement. Depletion was marginally lower in 2016 compared to 2015 commensurate with lower production and carrying values on Breagh partly offset by the commencement of depletion on Cladhan.

## IMPAIRMENT OF OIL AND GAS PROPERTIES

Due to cost and time overruns on the Cladhan UK offshore property, poorer than expected production and the drop in worldwide commodity prices, under RPS Energy Canada Ltd. ("RPS") pricing assumptions pay-out of the entire amount of the Second Carry (see "Financing Activities – Cladhan funding arrangements") is not now likely to occur and the liability has been re-measured to reflect the amount most likely to be repaid from future revenues of the 11.8 percent of the development being funded by TAQA. Under these same criteria, it is unlikely that the 11.8 percent asset will return to the Company and the remaining asset represents the amount of the revenues expected to be earned that will go to reduce the Second Carry. At September 30, 2016, after comparison of the carrying value and its fair value, the property has been impaired by \$15,718,000. The recoverable amounts were based on the value in use method and were determined at the level of the cash generating unit determined to be the Cladhan development oil and gas property. The recoverable amounts were based on discounted future cash flows over the next eight years, derived using proved plus probable reserves as at September 30, 2016. The cash flows (based on level III fair value hierarchy) used commodity prices based on RPS's reserves report and a pre-tax discount rate of 17 percent. In addition, the Company's wholly owned 2 percent of the field has been impaired by \$2,006,000 as at September 30, 2016 based on the same criteria above but using a pre-tax discount rate of 10 percent (the rate the Company uses for net present value investment decisions).

In the three month period ended September 30, 2015, Cladhan was impaired by \$8,497,000, and following the completion of the economic valuation of UK block 21/30f containing the Belinda discovery Sterling elected to withdraw from the licence resulting in an impairment of previously capitalised costs of \$1,279,000.

#### PRE-LICENCE AND OTHER EXPLORATION COSTS

For the nine month period ended September 30, 2016, pre-licence and other exploration costs expensed were \$951,000, a decrease of \$6,740,000 over the same period in 2015 (nine month period ended September 30, 2015 - \$7,691,000) as a result of lower activity in 2016 while in 2015 there was the expensing of activity on previously impaired assets in Romania and the UK. Of the total, \$810,000 (2015 – \$5,668,000) related to the Company's interests in its various licences in the UK, which were much higher in 2015 due to the remainder of the Crosgan well costs (\$4,846,000) and \$141,000 (2015 – \$1,068,000) which related to the Netherlands and other international ventures. In 2015, \$955,000 related to Romania, operations which were discontinued in August 2015.

## FOREIGN EXCHANGE

The Company's cash balances are generally maintained in the currencies in which they are expected to be utilized.

For the nine month period ended September 30, 2016, the Company recorded a foreign exchange loss of \$4,553,000. The foreign exchange loss derived from the strengthening of the US dollar (in which both the Bond (as defined herein) issued by the UK subsidiary and the Cladhan funding arrangements are denominated) against the UK pound (which is the functional currency for the UK subsidiary), with the partial offset being reduced by lower bank balances held in US dollars. This was similar to the nine month period ended September 30, 2015, where the Company recorded a foreign exchange loss of \$4,978,000 due to the strengthening of the US dollar in the first and third quarters of 2015, partly offset by a weakening US dollar against the UK pound in the second quarter of 2015.

## EMPLOYEE EXPENSE AND GENERAL AND ADMINISTRATION EXPENSE

	Three Months ended September 30		Nine Months ended September 30	
	2016	2015	2016	2015
	\$000s	\$000s	\$000s	\$000s
Gross employee, and general and administration expense	1,920	2,439	5,571	9,335
Recovered from third parties	(119)	(80)	(450)	(367)
Capitalized to assets	(56)	(172)	(218)	(673)
Expensed as pre-licence and other exploration expenditures	(132)	(776)	(780)	(2,904)
Total recoveries and allocations	(307)	(1,028)	(1,448)	(3,944)
Net employee expense	702	911	2,520	3,255
Net general and administration expense	911	500	1,603	2,136

## **EMPLOYEE EXPENSE**

For the nine month period ended September 30, 2016, net employee expense after allocations and recoveries was \$2,520,000, down from \$3,255,000 incurred in the same period in 2015 as a result of lower non-cash share based-compensation charges and the effects of staff reductions in 2015. Of the total, \$266,000 (down from the 2015 figure of \$685,000) relates to non-cash share-based compensation and \$2,254,000 relates to wages and salaries (nine month period ended September 30, 2015 - \$2,570,000). Recoveries and allocations are in general down compared to the corresponding period in 2015 due to lesser activity, particularly on operated assets and the sale of the Romanian business in the third quarter of 2015.

## **GENERAL AND ADMINISTRATION EXPENSE**

For the nine month period ended September 30, 2016, net general and administration ("G&A") expense after allocations and recoveries was \$1,603,000, a decrease of \$533,000 over the same period in 2015 due to cost saving initiatives partly offset by lower recoveries and legal and professional advisor costs set against the Recapitalization (as defined herein). In the first quarter of 2015, the Company made savings in G&A costs with a UK staff headcount reduction of 40 percent, and in the UK relocated its small London office and its Aberdeen office for a significant reduction in annual costs.

Following completion of the Recapitalization (see "Financing Activities"), the Company implemented further significant cost reduction initiatives consistent with a focus on maximizing cash flow from the UK Breagh gas field. The Company has closed both the Calgary and London offices, and all the operational, commercial and financial functions of the Company will now be conducted from the Aberdeen office. The Company completed the largest part of a staff reduction program by the end of the third quarter resulting in further significant cost savings going forward.

## REFINANCING AND STRATEGIC REVIEW

For the nine month period ended September 30, 2016, \$8,355,000 of non-recurring costs related to a refinancing and strategic review have been expensed. This amount consists of \$2,963,000 of costs incurred or accrued on severance payments as part of the staff reduction program, \$5,000,000 of bond amendment costs and \$392,000 of professional and legal fees related to the refinancing and strategic review. Various adviser fee costs directly attributable to the Recapitalization have now been capitalized and are amortized over the remaining life of the Bond and the SSRCF (see "Financing Activities").

For the nine month period ended September 30, 2015 the Company incurred \$14,889,000 of non-recurring costs related to a refinancing and strategic review: This includes \$9,563,000 representing amortization of the fees related to the First and Second Bond Amendment (as defined herein) (see "Financing Activities") and additional interest as a result of these amendments; \$1,620,000 relating to severance payments and \$3,706,000 of costs in relation to the sale of the Romanian business.

## **FINANCING COSTS**

Financing costs for the nine month period ended September 30, 2016, were \$21,204,000 (nine month period ended September 30, 2015 - \$20,387,000) consisting primarily of borrowing costs of \$12,200,000 on the Bond and amortization of Bond transaction costs of \$426,000. In the nine months ended September 30, 2015, interest expense of \$5,828,000 relating to the Cladhan funding arrangements was capitalized as borrowing costs until the asset entered into production in mid-December whereupon capitalization ceased and the interest expense began to be expensed. In the nine months ended September 30, 2016, \$8,218,000 of Cladhan funding arrangement interest was expensed.

The balance of the financing costs include accretion of the discount on decommissioning obligations and have decreased in the period due to lower cost estimates on the decommissioning obligations on the Breagh development.

# **INCOME TAXES**

In the UK, Sterling is subject to UK CT, currently at 30 percent, and SCT, which reduced from 32 to 20 percent with effect from January 1, 2015, and from 20 to 10 percent with effect from January 1, 2016 on its activities within the UK oil and gas ring fence. The reduction from 20 to 10 percent was substantively enacted during the third quarter.

Sterling has material UK tax losses available for offset against profits subject to corporate tax as a result of allowances generated principally by past exploration, appraisal and development costs including funding thereof and the application of ring fence expenditure supplement ("RFES") claims. CT losses at September 30, 2016 are estimated at £493 million (\$641 million) and SCT losses at £411 million (\$534 million) (lower than for CT, as financing costs are not allowable deductions for SCT).

Sterling presently forecasts that in the current low commodity price environment existing carried-forward UK tax losses as at September 30, 2016, will not sufficiently be utilized in the UK subsidiary company Sterling Resources (UK) Ltd. in future years, both against the reversal of existing taxable temporary differences and against future taxable profits from expected production from the Breagh and Cladhan fields. Under UK tax law, there is no statutory fixed time-limit determining an expiry of carried-forward UK tax losses. Accordingly, a UK deferred tax asset of \$57,867,000 as at September 30, 2016 (December 31, 2015 – \$66,073,000) has been recognized in the Balance Sheet, the difference relating to the SCT rate reduction and changes in foreign exchange rates partly offset by a reduction in the carrying value of assets in excess of their tax values.

Sterling expects to submit claims for RFES, which provides an uplift of 10 percent per annum (compounded) on eligible, cumulative ring fence tax losses, for 2015 and 2016. Sterling will also claim investment allowances on the Cladhan oil field and Breagh gas field on qualifying UK ring fence expenditure – these allowances are available to potentially shelter future taxable profits liable to SCT.

As at September 30, 2016, other principal tax losses and allowances available include tax pools of approximately \$3 million and non-capital losses of approximately \$33 million available to shield future income taxable in Canada and approximately \$22 million of tax deductible expenses and losses available to shield future taxable income in the Netherlands. The Canadian non-capital tax losses expire between 2031 and 2035 and the Netherlands losses expire over the next nine years from year of claim (for Dutch corporate income tax purposes only, there is no expiry for Dutch State Profit Share). There is no fixed time limit for the expiry of UK ring fence tax losses for CT and SCT. There is no deferred tax asset recognized on the non-UK losses.

#### UNREALIZED GAINS AND LOSSES ON DERIVATIVE FINANCIAL INSTRUMENTS

The original fair value of the repayment option on the Bond was determined to be \$5,861,000. On May 30, 2016 following the Recapitalization (see "Financing Activities") changes in the terms of the Bond led to this option being de-recognized and a new fair value of the repayment option was determined to be \$819,000. This was subsequently revalued at September 30, 2016, to be \$1,757,000. The call option on the Bond was valued using the Black-Karasinski model which takes into account interest rate volatility. Key inputs used in the model were related to the credit spread of the Company and the United States dollar discount curve. In the nine month period ended September 30, 2015, a gain on the revaluation of the repayment option on the Bond of \$1,341,000 was recognized.

In the second quarter of 2016, the Company purchased monthly cash-settled UK gas price put options from BNP Paribas and Citigroup to cover a proportion of the Company's expected production for a total consideration of \$4,155,000. The derivatives are revalued to their fair value at each period end. Any gain or loss is recorded through the income statement in the period in which it arose. At September 30, 2016 the derivatives were valued at \$1,766,000, \$251,000 recorded as a current asset as they will mature within the next twelve months and \$1,515,000 as a non-current asset. For the nine month period ended September 30, 2016, the Company recognized an unrealized loss of \$2,389,000.

In January 2015, the Company purchased monthly cash-settled UK gas price put options for the second and third quarters of 2015 at a strike price of 40 pence per therm (at National Balancing Point in the UK) for a volume equivalent to 4.0 Bcf of gas, or approximately 75 percent of expected production for that period, which have now expired. The put options were purchased from BNP Paribas and Vitol for a total consideration of approximately \$1.4 million. For the nine month period ended September 30, 2015, the Company recognized an unrealized loss of \$1,400,000.

For the nine month period ended September 30, 2016, the Company recognized an unrealized loss of \$1,048,000 on the combined movements in derivative financial instruments, compared to an unrealized loss on \$2,226,000 in the nine month period ended September 30, 2015.

## OVERVIEW AND SUMMARY OF RESULTS FOR THE EIGHT MOST RECENTLY COMPLETED QUARTERS

Under the Company's accounting policy for exploration and appraisal activity, its results from quarter to quarter are affected significantly by the level and success of its drilling program.

Note: The net income or loss for each quarter is calculated using the average rates for that quarter, while the cumulative period used elsewhere in the MD&A and financial statements is calculated using the average rates for that cumulative period. Therefore, due to exchange rate fluctuations, the aggregate of the quarters may differ from the cumulative period total. In addition, the net income or loss per common share for each quarter is required to be calculated independently of the calculation for the year. Consequently, due to the issuance of shares in a given year, the aggregate of the four quarters may differ from the year's total.

Key factors relating to the comparison of the net income or loss for the last eight quarters not discussed above are as follows:

- Since the Company recognized a deferred tax asset, the income statement has been subject to significant tax debits and credits as losses have increased, rates have changed and recoverability of those losses has altered dependent on the commodity price environment;
- In the first, second and third quarters of 2016, \$1,593,000, \$13,722,000 and \$2,739,000 of impairment of the Cladhan development has been charged to the income statement, respectively. In the third and fourth quarters of 2015, impairment of UK development and exploration and evaluation assets ("E&E") resulted in charges to the income statement of \$9,776,000 and \$28,127,000 respectively. In the fourth quarter of 2014, impairment of oil and gas properties resulted in an expense of \$45,275,000 on its Romanian exploration assets and \$33,144,000 on a number of UK development and E&E assets;
- The unrealized gains and losses on derivative financial instruments held by the Company varied significantly from quarter to quarter based on prevailing gas prices as well as the underlying inputs into the redemption option on the Bond;
- Throughout 2015, the Company incurred increased corporate costs relating to severance payments, costs in relation to the sale of the Romanian business and amortization of the costs of the First Bond Amendments and the Second Bond Amendments related to refinancing and a strategic review. This resulted in amounts of \$5,161,000, \$3,904,000, \$5,769,000 and \$5,778,000, respectively, being expensed to the income statement in the four quarters of 2015. In the first, second and third quarters of 2016, the Company incurred \$4,622,000, \$380,000 and \$3,228,000 respectively of non-recurring costs related to a refinancing and strategic review, mostly consisting of \$5,000,000 of Bond amendment costs, \$2,963,000 of costs incurred or accrued on severance payments and \$392,000 of professional and legal fees related to the refinancing and strategic review. Various adviser fee costs directly attributable to the Recapitalization have now been capitalized and are amortized over the remaining life of the Bond and the SSRCF (see "Financing Activities").; and
- Foreign exchange gains and losses varied significantly from quarter to quarter based on prevailing foreign exchange rates
  as well as amounts of monetary assets and liabilities held by various Company entities in currencies other than their
  functional currency.

## **DEVELOPMENT ACTIVITY**

The Company is pursuing no development in its own right. It will participate in the further development of Breagh by the operator. Otherwise it is looking to farm out any other development activity.

#### **BREAGH DEVELOPMENT**

Breagh production has averaged 69.5 million standard cubic feet per day ("MMscf/d") gross (21 MMscf/d net) through the third quarter of 2016. Gross condensate sales for the third quarter averaged 223 barrels per day ("bbls/d"), net 67 bbls/d to Sterling.

The infill drilling campaign is still expected to commence during the second quarter of 2017 with activity for the campaign expected to ramp up during fourth quarter of 2016 ahead of this start date. Also during the fourth quarter activity on the onshore compression project at Teesside Gas Processing Plant ("TGPP") will commence with full project sanction currently expected in the second quarter of 2017 with beneficial operation targeted for the first quarter of 2019.

Interpretation of the new seismic volume has continued throughout 2016 with final depth structure maps available in November. This work will facilitate new geological and reservoir models.

# **FORWARD VIEW**

With the continued strong performance of the Breagh field, 2016 full year sales gas production forecast is maintained at previous guidance average of 71 MMscf/d for 100 percent of the field (21.3 MMscf/d net).

Following completion of the seismic interpretation work the build of new geological and reservoir models is planned to feed in to investment decision on the infill drilling campaign in early 2017. The anticipated infill drilling campaign of two new wells (A09 and A10) in the Breagh field and the re-entry and hydraulic stimulation of one existing well to improve performance commencing during the second quarter of 2017, remains unchanged from previous reporting. Two further wells (A11 and A12), and a further hydraulic stimulation of another existing well could follow on as part of the same drilling campaign. In addition, a limited scope intervention on well A04 was completed mid November 2016 to restart this non-producing well and results are currently being evaluated.

At this time Phase 2 development planning remains on hold to prioritise the infill drilling campaign from the Breagh A platform. It is expected that reservoir data from the infill drilling campaign coupled with the updated 3D seismic interpretation work and new models will lead to restart of Phase 2 planning in the latter half of 2017.

The development cost for the remainder of Breagh Phase 1, reflecting the drilling and stimulation plans outlined above (with two new wells and one existing lower performance well to be re-entered, side-tracked and stimulated) together with the onshore compression project to be installed over 2017-2018, is anticipated to be approximately \$40 million net to the Company from October 1, 2016 as advised by the field operator Ineos UK SNS Limited. On a cash basis, this is expected to be phased \$2 million in the fourth quarter of 2016, \$23 million in 2017, \$13 million in 2018 and \$1 million in 2019. Pre-sanction costs for Breagh Phase 2 are expected to amount to less than \$1 million net to the Company in 2017.

#### **CLADHAN DEVELOPMENT**

First production from the Cladhan development was achieved in mid-December 2015. Cladhan production averaged 5,950 bbl/d gross during the third quarter (119 bbl/d net to Sterling). Production well P2 flow rate declined significantly during the second quarter and has remained shut in since mid-July. Full year average production is forecast to be 6,620 bbl/d gross (132 bbl/d net to Sterling) for 2016.

#### **EXPLORATION AND EVALUATION ACTIVITY**

During the nine month period ended September 30, 2016, and up to the date of this report, key exploration and evaluation activities were as follows:

#### **UNITED KINGDOM**

On the Crosgan licence (block 42/10a & 42/15a, Sterling 30 percent, non-operator) following the drilling and abandonment of an appraisal well 42/15a-3 completed in February 2015, approximately half the licence area was surrendered in February 2016. No amounts are currently capitalized for this licence.

On blocks 42/3a, 42/4, 42/5 & 36/30 (Sterling 100 percent), which are located approximately 25 kilometres north of the Breagh gas field and contain the Carboniferous Darach and Permian reef Ossian prospects, the Company continues a farm-down process for its interest during 2016 ahead of drilling a commitment well. The UK Oil & Gas Authority ("OGA") has agreed to extend the licence expiry date to December 2018, by which time the commitment well needs to be drilled.

Sterling retains a 100 percent interest in block 49/19b which contains the Niadar prospect, and OGA has extended the licence to December 2017 while the Company continues a farm-down process.

The licence covering blocks 42/13b, 42/17a and 42/18a containing the Lochran prospect was relinquished effective March 15, 2016. No amounts are currently capitalized for this licence.

In comparison, during the nine month period ended September 30, 2015 on the Crosgan gas discovery (block 42/10a & 42/15a, Sterling 30 percent, non-operator) an appraisal well 42/15a-3 completed drilling in February 2015. The Crosgan well spudded in November 2014 using the Ensco 70 rig, following on from the drilling activity on the Breagh field. The well reached a total measured depth of 8,401 feet and encountered gas bearing sands in the Carboniferous Yoredale Formation. The gas sands were however thinner and deeper than prognosis and the well has been plugged and abandoned. The carrying amounts on Crosgan were fully impaired at December 31, 2014 and additional drilling costs of \$4,846,000 were expensed as other exploration costs in the first quarter of 2015. Other key exploration and appraisal activity and expenditures focused on preparation for the drilling of an exploration well on the Beverley oil prospect in block 22/26c in the UK North Sea.

## **NETHERLANDS**

Seismic processing was completed during September 2015. Seismic inversion work commenced in July 2016 and seismic mapping of key reservoir horizons continues. In July 2016, further licence extensions were granted until January 2021.

# FRANCE

Letters requesting the withdrawals of the extension application for the St. Laurent licence (Sterling 33.42 percent, non-operator) containing the Grenade discovery and the initial application for the Donzacq licence (Sterling 33.42 percent, non-operator) have been submitted. Formal approval of the works on the abandonment and site restoration of the Grenade-3 well, conducted in the fourth quarter of 2015, are expected by the end of 2016.

## **FINANCING ACTIVITIES**

#### RECAPITALIZATION

On May 30, 2016 (the "Recap Closing Date"), the Group completed a recapitalization (the "Recapitalization") pursuant to a recapitalization agreement (the "Recapitalization Agreement") involving the Company, its subsidiary, Sterling Resources (UK) Ltd. ("SRUK") and Nordic Trustee ASA (the "Bond Trustee") in relation to the senior secured bond (the "Bond") issued by SRUK pursuant to a bond agreement originally dated May 2, 2013, as subsequently amended (the "Bond Agreement"). The Recapitalization was required as a result of the Company and SRUK being unable to implement a financing, asset/corporate sale or merger transaction by February 29, 2016 as required by the Third Bond Amendments (as defined below). The principal elements of the Recapitalization were a rights offering, a bond exchange, an internal transfer of SRUK, further amendments to the terms of the remaining Bonds, provision of new funding via a super senior revolving credit facility and certain other actions all as described below.

(i) **Rights Offering.** The Company conducted a rights offering (the "Rights Offering") by way of short form prospectus to the holders of its Common Shares on the record date of April 27, 2016 pursuant to which eligible shareholders received rights entitling them to purchase an aggregate of 14,277,525,577 Common Shares at a subscription price per Common Share of Canadian Dollar ("C\$") 0.015398 (the "Subscription Price"). The Rights Offering closed on May 30, 2016 and raised proceeds of C\$1,303,647 for the issuance of 84,663,364 Common Shares.

The gross proceeds of the Rights Offering, after such funds were converted to US dollars and less a foreign exchange adjustment, of \$989,860 (the "Rights Offering Proceeds"), were used solely to fund the release and cancellation of a portion of the liabilities of the Company and SRUK under or in connection with the Bonds, comprising principal, redemption premium, accrued (but unpaid) amendment fees and interest (the aggregate of all such liabilities being the "Bond Liabilities" and the amount so released and cancelled with the Rights Offering Proceeds being the "Purchased Liabilities"). The expenses associated with the Rights Offering were paid from the general funds of the Company.

(ii) **Bond Exchange.** The Bondholders (as defined herein) (directly, or indirectly through an affiliate, or through the Bond Trustee) subscribed for the unsubscribed 14,192,862,213 Common Shares under the Rights Offering (the "Exchange Shares") at the same price per Common Share as the Rights Offering Subscription Price. The value of the Exchange Shares, converted to US dollars on the date of the final prospectus, amounted to \$173,088,621 (the "Exchange Amount"). The consideration for the Exchange Shares was, indirectly, the full and final satisfaction of Bond Liabilities equal to the Exchange Amount (the "Exchanged Bond Liabilities").

Immediately prior to the Recap Closing Date, the Bond Liabilities amounted to \$214,340,000. After the release/cancellation of Purchased Liabilities and the Exchanged Liabilities, the remaining Bond Liabilities immediately after the Recap Closing Date were \$40,261,519, all in the form of Bond principal (the "Remaining Bonds").

As a result of the Bond Exchange and the issuance of Common Shares pursuant to the Rights Offering, the aggregate equity held by the holders of Common Shares prior to the Recapitalization was diluted to approximately 3.58 percent of the total equity of the Company after completion of the Recapitalization. Bondholders acquired Common Shares aggregating to approximately 96.4 percent of the Common Shares after completion of the Recapitalization.

- (iii) **Transfer of SRUK.** On the Recap Closing Date, the Company transferred the entire share capital of SRUK to a new wholly-owned subsidiary governed by the laws of England and Wales, SRUK Holdings Ltd ("SHL"), in order to provide additional security to Bondholders and lenders under the SSRCF (as defined below) and greater flexibility in any future refinancing of the SSRCF and the Bonds post-Recapitalization.
- (iv) Remaining Bonds. On the Recap Closing Date, SRUK and the Company entered into a further amended and restated Bond Agreement with the Bond Trustee (the "Fourth Bond Amendment Agreement") for the purpose of setting out the revised terms and conditions governing the Remaining Bonds, as described below under "Bond". The amount of the Remaining Bonds was approximately \$40.3 million as at May 30, 2016, as described under "Bond Exchange" above.
- (v) Super senior revolving credit facility. On the Recap Closing Date, the Company and SRUK entered into an agreement for a new loan with two of the Bondholders or their affiliates (the "Senior Lenders") as described under "Super Senior Revolving Credit Facility" below.

(vi) Other actions. A number of further agreements and actions were provided for in the Recapitalization Agreement. On the Recap Closing Date, the Company and SRUK also entered into an intercreditor agreement (the "Intercreditor Agreement") with the Senior Lenders and the Bondholders. Each of the Company and its affiliates (including SHL) also executed the guarantees and security documents contemplated in the Fourth Bond Amendment Agreement and the Super Senior Revolving Credit Facility. An Exit Fee (as defined herein) letter entered into between the Company and the Bond Trustee pursuant to the Amendment and Restatement Agreement No. 3 (as described in the Company's news release of October 22, 2015) was terminated on the Recap Closing Date. Pursuant to the Recapitalization Agreement, shortly after the Recap Closing Date, the Company conducted its annual and special meeting of shareholders held on July 5, 2016, at which was passed, among other things: (a) a resolution approving the creation of a new "Control Person" (as defined in TSX Venture Exchange ("TSXV") Policy 1.1 – Interpretation) created as a result of the Bond Exchange; and (b) a special resolution approving the 100:1 Consolidation of the Common Shares.

#### **BOND**

In April 2013, SRUK (the "Issuer") completed the issuance of the Bond, which is listed on the Nordic Alternative Bond Market in Oslo (under the ticker STRE01 PRO) but not actively traded. The Bond Agreement has been amended and restated as a result of four sets of amendments approved by holders of the Bond ("Bondholders"), firstly in December 2014 (the "First Bond Amendments"), secondly in May 2015 (the "Second Bond Amendments"), thirdly in November 2015 (the "Third Bond Amendments") and fourthly in May 2016 (the "Fourth Bond Amendments"). These four sets of amendments led to the entry into the Amended and Restated Bond Agreements No. 1, 2, 3 and 4, respectively.

The Bond is governed by Norwegian Law and the trustee for the Bond is Nordic Trustee ASA (formerly Norsk Tillitsmann ASA; the "Bond Trustee"). Note SRUK has changed its legal form twice (for tax and security related considerations), from a limited company at the time of the original Bond issue to a public limited company and, in January 2016, back to a limited company.

The Bond was originally set to mature on April 30, 2019 but pursuant to the Fourth Bond Amendments this has been extended to April 30, 2020. At the time of issuance, the Bond carried an interest coupon of 9 percent payable in cash semi-annually on April 30 and October 30 of each year. Pursuant to the Second Bond Amendments the coupon was increased to 14 percent per annum (paid in cash) as from October 30, 2015 and pursuant to the Fourth Bond Amendments, the coupon dropped back to 9 percent per annum calculated from the Recap Closing Date and will be paid in kind until the date the SSRCF is repaid, prepaid or cancelled (the "SSRCF Discharge Date") and thereafter paid in cash. To the date of this report, all interest payments have been paid in full when due.

At the time of issue, the Bond was callable (prepayable) at the option of SRUK at any time with a call price of 105 percent of par value for the first three years (with a roll-up of outstanding interest for the first two years), a call price of 103.5 percent of par value in year four, 102 percent in year five, and finally 101 percent and 100.5 percent for the first and second halves of the final year. Pursuant to the Second Bond Amendments, the call price was set at 107.5 percent of par value from May 1, 2015 until maturity. Pursuant to the Fourth Bond Amendments, the call price has been decreased to par value from the Recap Closing Date until maturity.

Commencing on October 30, 2014, the Bond began to amortize 10 percent of the issue amount every six months. At the time of issue, the amortization instalments were due to be performed at a price of 105 percent of par value except for the final instalment which would be repaid at 100 percent of par value. Pursuant to the Second Bond Amendments, the amortization price was set at 107.5 percent of par value for all instalments from April 30, 2015 onwards. In order to avoid a potential payment default, the amortization instalment due on April 30, 2015 (the "April 2015 Instalment") was deferred until the closing of the Romanian Sale (as defined herein) on August 26, 2015, in accordance with the Second Bond Amendments. For the same reason, the amortization instalment due on October 30, 2015 (the "October 2015 Instalment") was deferred pursuant to the Third Bond Amendments until the earlier of (i) completion of a financing, corporate sale, or asset sale transaction leading to a full redemption of the outstanding Bonds (including the 7.5 percent call premium, and accrued interest and other related costs), or (ii) February 29, 2016. As a result of the two instalments paid on October 30, 2014 and on August 26, 2015, the outstanding Bond principal immediately prior to the Recapitalization was \$180 million. Pursuant to the Recapitalization Agreement, immediately after the Recap Closing Date the principal amount of the Remaining Bonds was reduced to \$40,261,519 (as described under "Bond Exchange" above) with no associated accrued and unpaid redemption premium, amendment fees or interest. Repayment will occur via a cash sweep (subject to various tests) after the SSRCF Discharge Date with any final balance under the SSRCF repayable as a single sum on maturity.

Pursuant to the original Bond Agreement, on the 30<sup>th</sup> day of each month from October 2013, a sum equal to one sixth of the sum of the next semi-annual interest payment and debt amortization payment was to be made to the Debt Service Retention Account ("DSRA") (such transfers being the "Monthly Transfers"). The DSRA is charged and blocked in favour of the Bond Trustee. Pursuant to the First and Second Bond Amendments, no Monthly Transfers were made from November 2014 until October 2015 inclusive

and pursuant to the Third Bond Amendments, the requirement for Monthly Transfers was deleted. Pursuant to the Fourth Bond Amendments, the Monthly Transfers have been reinstated such that the first Monthly Transfer will be made in the month following the SSRCF Discharge Date.

There is a wide-ranging guarantee and security package in favour of the Bondholders and, from the Recap Closing Date, in favour of the Senior Lenders. The security agent is now GLAS Trust Corporation Limited acting on behalf of the Bondholders and the Senior Lenders. The Senior Lenders have a senior ranking for the purposes of the guarantee and security as set out in the Intercreditor Agreement. Guarantees are provided by the Company, SHL and SRUK. The security package includes a charge over the Issuer's interests in the Breagh and Cladhan fields, charges over the shares of SHL and SRUK and pledges over certain bank accounts. An additional security agreement providing an assignment of certain of the Company's receivables relating to a sale of part of a Romanian licence to ExxonMobil and other parties in 2012 is no longer in effect following a relinquishment of the relevant licence by ExxonMobil and its partners as of August 4, 2016.

Net proceeds from the Romanian Sale received in August 2015 of approximately \$27.4 million (being gross proceeds less a cash payment to Gemini, transaction-related taxes and reimbursement to Sterling of allowable transaction fees already paid; see "Romanian Sale") were applied pursuant to the cash waterfall provisions set out in the Second Bond Amendments. \$24.8 million of this amount was used to pay Bondholders the outstanding April 2015 instalment (together with 7.5 percent amortization premium and accrued interest) and the remaining \$2.6 million was transferred to the DSRA and was used towards funding the interest payment made on October 30, 2015. Further transfers to the DSRA resulting from the application of the cash waterfall were made upon the post completion settlement of the Romanian Sale and following the receipt of a refund of Romanian VAT.

Prior to the Fourth Bond Amendments, there were two financial covenants under the Bond Agreement: first, SRUK was required to maintain at all times a minimum level of liquidity (unrestricted cash and cash equivalents) of \$10 million and secondly, at the consolidated group level, the Company was required to maintain at all times a minimum equity ratio of 40 percent (defined as total Equity divided by total Assets calculated in accordance with IFRS). Pursuant to the First Bond Amendments, the minimum UK liquidity was reduced on a temporary basis to \$7.5 million from November 30, 2014 to January 30, 2015 and to \$10 million from January 31, 2015 onwards. Pursuant to the Second Bond Amendments, the minimum UK liquidity was reduced to \$5 million from October 31, 2015 onwards. Pursuant to the Third Bond Amendments, the minimum UK liquidity was kept at \$5 million from October 30, 2015 to November 29, 2015, and increased to \$7.5 million from November 30, 2015 to February 28, 2016. The minimum UK liquidity was kept at \$7.5 million pursuant to an amendment letter dated February 29, 2016 and was reduced to \$5 million from March 18, 2016 pursuant to an amendment approved at a Bondholder meeting on that date. Pursuant to the Fourth Bond Amendments, from the Recap Closing Date further changes to the financial covenants became effective, as follows:

- i) a minimum liquidity requirement is calculated at a level of \$5 million for the Company and its subsidiaries (collectively, the "Group") until maturity, to be satisfied at all times;
- ii) the minimum equity ratio requirement is deleted;
- iii) a minimum field life cover ratio (corporate net present value divided by total SSRCF debt) of 1.5x, dropping to 1.0x after the date of the SSRCF Discharge Date, to be tested at the end of each quarter and upon certain other events;
- iv) cumulative production for the previous 12 months (or a shorter period during 2016) of not less than 90 percent of the budgeted amount, to be tested at the end of each month;
- v) projected liquidity of \$5 million (on a Group basis) until the Bond maturity date (excluding in any such projection the repayment of the Bond on maturity), to be tested at the end of each quarter after the SSRCF Discharge Date; and
- vi) a minimum debt service cover ratio of 1.0x, calculated over the previous 12 months (or a shorter period during 2016), to be tested at the end of each quarter from the end of the second quarter after the SSRCF Discharge Date.

FTI Consulting, a financial adviser, was appointed by the Bond Trustee in April 2015 at Sterling's cost to review the Company's assets, cash flows and sale/financing initiatives in support of the Second Bond Amendments. In addition, pursuant to the Second Bond Amendments, Sterling appointed Jefferies International in July 2015 as its strategic financial adviser to assist the Company in the assessment and implementation of strategic options available to it including a sale of all or part of its assets.

Pursuant to the First Bond Amendments, an amendment fee of \$2.5 million was paid to bondholders in December 2014. Pursuant to the Second Bond Amendments, an amendment fee of \$3 million was paid to Bondholders in May 2015 and two further amendment fees, each of \$750,000, were paid to Bondholders in July and August 2015 as a result of completion of the Romanian Sale being delayed beyond July 15, 2015. Pursuant to the Third Bond Amendments, an initial amendment fee of \$1 million was paid to Bondholders in November 2015 and additional amendment fees of \$6 million were due within five business days of February 29, 2016 as a result of the Bond not having been redeemed by that date. Pursuant to the Recapitalization Agreement, the aggregate additional amendment fees of \$6 million were included in the Bond Liabilities cancelled as a result of subscriptions received in the Rights Offering or exchanged into new Common Shares as a result of the Bond Exchange.

The Third Bond Amendments also included the introduction of a potential "Exit Fee" which may have been payable after bond redemption, being effectively 20 percent of the incremental final (post bond redemption) equity value above a 100 percent increase on the initial equity value (measured prior to approval of the Third Bond Amendments), payable in cash and/or common shares in Sterling Resources Ltd. and subject to certain adjustments and conditions. The requirement for this Exit Fee was cancelled from the Recap Closing Date, pursuant to the Recapitalization Agreement. In addition, the Third Bond Amendments required the appointment of an Independent Director to the board of directors of the Company (subsequently amended to the appointment of a board observer) and SRUK, as nominated by the Bond Trustee.

As at September 30, 2016, and to the date of this report, the Company was in compliance with the terms of the Bond (as amended and with waivers provided by Bondholders).

#### SUPER SENIOR REVOLVING CREDIT FACILITY

On the Recap Closing Date, the Company and SRUK entered into an agreement for a new loan with two of the Bondholders or their affiliates (the "Senior Lenders") in the form of a super senior revolving credit facility (the "SSRCF") of up to \$40 million. The SSRCF comprises two tranches, A and B, each of \$20 million and both on a revolving, multi-currency basis. Tranche A is to be used first, up to \$10 million for general corporate purposes and for capital expenditures in accordance with the relevant annual budget. Tranche B, if required, is for capital expenditures only in accordance with the relevant annual budget. The final maturity date is 24 months after the Recap Closing Date, with an optional extension to April 30, 2019 subject to satisfying certain conditions. There is a 7 percent arrangement fee on each Tranche, for Tranche A paid in cash on the Recap Closing Date and for Tranche B to be paid in cash upon the earlier of the date of first utilization of Tranche B and the date falling 24 months after the Recap Closing Date (provided that no fee shall be payable if the SSRCF is cancelled in full before that date).

The interest rate for each tranche is the aggregate of the margin and LIBOR (subject to a LIBOR floor of 1 percent). The margin for Tranche A is 13 percent per annum, and for Tranche B 13 percent per annum increasing 100 basis points each quarter from drawdown of Tranche B (subject to an overall cap of 15 percent per annum). Interest is calculated from the date of utilization of each Tranche until the date the relevant Tranche is repaid, prepaid or cancelled, and paid semi-annually on 30 April and 30 October. Tranche A interest is paid in cash and Tranche B interest is paid in kind (i.e. added to the principal amount). There is a commitment fee on the unused part of each tranche equal to half of the applicable margin, paid on each interest payment date; for Tranche A paid in cash and for Tranche B, paid in kind but only if Tranche B is utilized. There is a cancellation premium on Tranche A and (if used) Tranche B, equal to the relevant commitment fee on the cancelled amount calculated from the date of cancellation to the applicable final maturity date.

Financial covenants are essentially the same as those applying for the Remaining Bonds (save for those financial covenants which only apply from the discharge date of the SSRCF) and in addition there are utilization conditions which comprise, on a simplified basis: (i) a minimum interest cover ratio (EBITDA to SSRCF cash charges) of 1.0x, (ii) a minimum 4-year Rolling Net Present Value cover ratio of 1.3x, (iii) a minimum group cash requirement of \$5 million on a projected basis until the SSRCF discharge date and (iv) ) in relation to a Tranche B utilization only, a minimum field life cover ratio of 1.75x. The SSRCF will have senior ranking in relation to guarantees and security package as described under the Bond, as set out in the Intercreditor Agreement.

As of September 30, 2016, the balance of the SSRCF was zero and from the Recap Closing Date through to the date of this report the SSRCF has not been utilized.

# **ROMANIAN SALE AND CARVE-OUT TRANSACTION**

On August 26, 2015, the Company completed the sale of its remaining Romanian business (the "Romanian Sale") to Carlyle International Energy Partners ("Carlyle"). The sale included licence blocks 13 Pelican, 15 Midia and 25 Luceafarul, structured as a corporate sale of the Company's wholly-owned subsidiary Midia Resources SRL and was first announced on March 26, 2015.

The headline consideration for the transaction was \$42.5 million. In addition, Carlyle also reimbursed Sterling approximately \$1.4 million in costs incurred by Midia Resources SRL between signing and completion ("Interim Period Costs"), of which half was paid

on completion and the other half (subject to adjustments) was paid as a post completion settlement in December 2015. Sterling received an initial cash payment of approximately \$40.5 million from Carlyle, which is \$42.5 million less an amount withheld on account of Romanian VAT of approximately \$2.7 million plus approximately \$0.7 million as half of the Interim Period Costs. Subsequent to completion, Sterling filed a quarterly return, subject to future tax audit, for Romanian corporate tax in October 2015 showing an overall net capital loss and hence no corporate tax liability arising from the transaction (after taking into account the availability of tax deductible past costs and losses). The VAT amount with minor adjustments was refunded to Sterling in March 2016, together with a refund of \$0.8 million relating to past costs unrelated to the Romanian Sale. No Canadian corporate tax is expected to be payable as a result of available tax deductions.

Concurrent with the Romanian Sale, Sterling terminated the investment agreement signed with Gemini in 2007 for a cash consideration of \$10 million (the "Gemini Cash Payment") and the issuance to Gemini of 60,372,876 Common Shares with a market value at the time of issuance of \$7.5 million.

Net of the Gemini Cash Payment, transaction-related taxes and reimbursement to Sterling of allowable transaction fees already paid, an initial amount of approximately \$27.4 million out of the Romanian Sale proceeds was applied pursuant to the cash waterfall provisions of the Bond Agreement (see "Financing Activities – Bond").

Because the sale closed more than two months after July 15, 2015, Sterling made two payments to Bondholders each of \$0.75 million, in accordance with the Bond Agreement.

The Company's interest in block 27 Muridava was sold to Petroceltic Resources PLC in June 2015. This sale was contemplated in the Romanian Sale agreement and the consideration for the Romanian Sale was unaffected. Consideration for the Muridava sale was non-material and the buyer accepted all of the outstanding obligations relating to the licence.

Sterling's entitlement to further contingent payments from the completed sale of its 65 percent interest in a portion of the Midia Block in the Romanian Black Sea (the "Carve-out Portion") to ExxonMobil Exploration and Production Romania and OMV Petrom S.A., which was announced on January 29, 2014, will not now occur following the purchasers' recent relinquishment of the Carve-Out Portion.

#### **CLADHAN FUNDING ARRANGEMENTS**

In April 2013, the Company signed agreements with TAQA which ensured that the Company was in a position, regardless of the closing of the then contemplated Bond, to submit evidence of funding ability for its share of the development costs of Cladhan to the UK Department of Energy and Climate Change by April 17, 2013 to enable field development plan approval. In conjunction with an earlier non-repayable carry arising from a transaction with TAQA in 2012 (the "First Carry"), these agreements also provided for a full carry of the then anticipated development capital costs until first oil, anticipated in 2015. As part of the 2013 transaction, the Company made a permanent transfer of a 12.6 percent interest in the Cladhan field to TAQA in exchange for a repayable carry by TAQA of development expenditures on an 11.8 percent interest in Cladhan (the "Second Carry"), which was transferred to TAQA for the duration of the carry. Transfer of the 12.6 percent interest was completed in August 2013 and the Second Carry became available.

Pursuant to these TAQA funding arrangements, the Company retains a minimum 2 percent interest in Cladhan throughout, for which the original budgeted development cost is funded out of a portion of the fixed First Carry. The rest of the First Carry, which amounted to \$53.6 million in total at December 31, 2013, was available to fund development costs on the 11.8 percent interest and was fully utilized in the third quarter of 2014, at which point the Second Carry started to fund the ongoing development costs for the 11.8 percent interest only. A 17 percent per annum uplift is applicable to the balance of the Second Carry.

Due to cost and time overruns on the project and the drop in worldwide commodity prices, under the RPS, the Company's reserve auditors, pricing assumptions used in the Company's 2015 reserves report effective December 31, 2015 dated April 14, 2016 ("NI 51-101F1"), pay-out in full of the Second Carry is not now likely to occur and the liability has been re-measured to reflect the amount most likely to be repaid from future revenues of the 11.8 percent. The Second Carry balance has been re-measured down to \$17,462,000, with \$7,601,000 recorded as a current liability on the balance sheet as it is expected to reduce the carry over the next twelve months and \$9,861,000 was recorded as a non-current liability expected to be the balance of the carry that will be repaid. The recoverable amounts were based on the value in use method and were determined at the level of the cash generating unit determined to be the Cladhan development oil and gas property. The recoverable amounts were based on discounted future cash flows over the next eight years, derived using proved plus probable reserves as at September 30, 2016. The cash flows (based on level III fair value hierarchy) used commodity prices in the NI 51-101F1, produced by RPS, effective December 31, 2015 price forecast taking into account actual production in the first nine months of 2016 and a pre-tax discount rate of 17 percent. If the Second Carry does not pay-out Sterling has no further liability to TAQA regarding the 11.8 percent interest. The resulting reduction

in the amount of liability that was due to be paid under the carry arrangements has seen a credit of \$29,574,000 recorded in the income statement (year ending December 31, 2015 - \$22,655,000). The corresponding 11.8 percent asset has also been impaired down to the same level as the non-financial liability and recorded under impairment of oil and gas properties.

In the event of a large increase in commodity prices and pay-out does occur then provided the remaining net present value of the field is positive, the 11.8 percent interest will be returned to Sterling whose equity interest would then be 13.8 percent. Sterling retains the contingent upside payments linked to future reserves pursuant to the First Carry.

## FINANCING, LIQUIDITY AND SOLVENCY

## **Net Working Capital**

As at	September 30, 2016	December 31, 2015
	\$000s	\$000s
Cash and cash equivalents	7,658	10,889
Restricted cash	135	1,306
Trade and other receivables	3,087	8,369
Inventory	704	325
Prepaid expenses	2,510	227
Derivative financial asset	251	-
Trade and other payables	(4,463)	(7,113)
Accrued interest payable	-	(3,277)
Current portion of decommissioning obligations	-	(722)
Current portion of long-term debt	-	(189,593)
	9,882	(179,589)

Net working capital, defined as current assets less current liabilities excluding the Cladhan funding arrangements, was a surplus of \$9,882,000 as at September 30, 2016, and has improved due to the completion of the Recapitalization (see "Financing Activities"). Prior to the Recapitalization all the debt was repayable and was treated as a current liability. Both trade and other receivables and payables are at lower levels compared to December 31, 2015 due to lower activity. The Cladhan funding arrangements (see "Financing Activities") will be repaid from oil revenues from the 11.8 percent interest in the property currently held by TAQA and have therefore been excluded from the net working capital calculation.

There were no term deposits in place at September 30, 2016 (December 31, 2015 – \$9,729,000).

As at September 30, 2016, the Company's receivables included \$2,132,000 of revenue receivable from Breagh gas sales which was paid in October 2016 (December 31, 2015 - \$4,524,000).

Trade and other payables of \$4,463,000 as at September 30, 2016 were mainly comprised of accrued expenditures related to the Breagh asset (December 31, 2015 - \$7,113,000).

## **COMMITMENTS AND CONTINGENCIES**

Commitments as at September 30, 2016 for the years 2016 through 2020 and thereafter, comprise the following:

	2016	2017	2018	2019	2020	Thereafter	Total
	\$000s	\$000s	\$000s	\$000s	\$000s	\$000s	\$000s
Facilities, oil and gas drilling	1,589	18,158	17,639	-	-	-	37,386
Licence fees	168	1,101	1,094	1,032	1,055	-	4,450
Other operating	138	350	295	126	-	-	909
Office and other leases	226	535	496	488	488	-	2,233
	2,121	20,144	19,524	1,646	1,543	-	44,978

The above facilities, oil and natural gas drilling commitments in 2016 relate to additional work on Breagh Phase 1 development costs and amounts for long lead items for drilling in 2017. One exploration/appraisal well is shown at 100 percent in each of 2017 and 2018 as commitments though it is possible these would progress under a farm-in agreement with these costs shared.

Costs under facilities, oil and gas drilling, office and other leases and other operating categories have reduced following the Romanian Sale (see "Financing Activities") as these have all been transferred to Carlyle to the extent they relate to the Romanian business.

Included in the table above under the office and other leases subtotal is a commitment for office space that was assigned to a third party in December 2013. Under the terms of the sublease, Sterling continues to be liable to the landlord for any default under the lease caused by the assignee. It is expected that approximately \$2,074,000 of the office and other leases commitment will be covered by this sub-lease.

#### LIQUIDITY AND SOLVENCY

The Company's consolidated net working capital surplus as at September 30, 2016, was \$9,882,000 compared to a net working capital deficit of \$179,589,000 as at December 31, 2015. The Company's liquidity position has been materially improved since December 31, 2015 by completion of the Recapitalization (see "Financing Activities – Recapitalization") and previously by entering into the First Bond Amendments, Second Bond Amendments and Third Bond Amendments (see "Financing Activities – Bond"), and certain other short term waivers and amendments to the Bond Agreement. As a result of the First Bond Amendments, the requirement to make a monthly transfer to the DSRA at the end of November 2014 was cancelled. Pursuant to the Second Bond Amendments, the requirement to pay the April 2015 instalment to Bondholders was deferred until completion of the Romanian Sale in August 2015. The requirement to pay the October 2015 Instalment was postponed pursuant to the Third Bond Amendments. Finally, the Recapitalization resulted in the reduction of Bond Liabilities from \$214.3 million to \$40.3 million and the provision of up to \$40 million of new funding available in the form of the SSRCF. Pursuant to the Fourth Bond Amendments, Bond interest is payable in kind prior to cancellation of the SSRCF and no prepayments of the Bond are required prior to cancellation of the SSRCF. The Company expects to be able to refinance the SSRCF and the Bond prior to the SSRCF maturity date, possibly through a bank market reserves-based loan.

From October 1, 2016 to December 31, 2019, the Company has commitments amounting to approximately \$45 million (see "Commitments and Contingencies"), of which \$36 million arises from UK exploration well drilling costs, with much smaller committed costs thereafter. The Company is looking to farm-down these exploration licences or seek further licence extensions so that it would not incur such costs in this time period. In addition, expected (but not committed) capital expenditures on the UK Breagh field over this same three and a quarter year period on the assumption of drilling wells A09 and A10 and installing onshore compression is expected to amount to approximately \$40 million (see "Development Activity - Breagh Development -Forward View"), again with much smaller committed costs thereafter. The Company has modelled its expected future net cash flows (excluding the \$36 million of UK exploration well drilling costs) on the basis that the Company is looking to farm-down these exploration licences or seek further licence extensions so that it would not incur such costs through to the end of 2019. Through to April 2020 (the maturity date of the Bond) at recent forward curve prices, any usage of the SSRCF is expected to be minimal. Beyond this period, the Company expects cash balances to grow for several years. In this regard, in the Company's view, the key risks are interruptions to production from Breagh and lower than expected UK gas prices. The Company has mitigated the risk of the former by insuring for loss of production income and has mitigated the risk of the latter through gas price hedging. Taken together with these intended mitigation measures, the Company expects the availability of up to \$40 million of additional funding from the SSRCF to provide sufficient headroom to meet all reasonable downside scenarios of operating and financial performance. Consequently, the Directors are satisfied that the Company should be able to continue as a going concern for the foreseeable future.

## **DECOMMISSIONING OBLIGATIONS**

The Company's decommissioning obligations result from net ownership interests in petroleum and natural gas interests in which there has been exploration, appraisal and development activity. The provision is the discounted present value of the estimated cost, using existing technology at current prices. The Company estimates the total undiscounted amount of cash flows required to settle its decommissioning obligations as at September 30, 2016 to be approximately \$45,776,000, which will be incurred between 2016 and 2036. Two wells on the Sheryl licence were abandoned during the third quarter of 2016 and this portion of the decommissioning obligation, \$660,000, previously recognized as a current liability has been derecognized. Risk free interest rates based on UK long-term government bond rates varying from 0.77 percent to 1.57 percent (December 31, 2015 – 1.37 to 2.39 percent) and an inflation rate of 2 percent (December 31, 2015 – 2 percent) were used to calculate the longer term decommissioning obligations at September 30, 2016. The reduction in the interest rates resulted in a revision to the

decommissioning obligation estimates of \$5,106,000 in the nine months ended September 30, 2016. During the year ended December 31, 2015 the Company sold its Romanian business including all decommissioning obligations resulting in an obligation disposal of \$2,354,000 and completed the non-operational abandonment of the Grenade well in France resulting in a further obligation disposal of \$55,000. Decommissioning obligations arising in the year ended December 31, 2015 relate to facilities related to the Cladhan development. Decommissioning estimates for the Cladhan development are currently calculated at an equity percentage of 2 percent, but may rise to 13.8 percent in the event of repayment of the Cladhan funding arrangements (See "Financing Activities"). Revisions to estimates in the year ended December 31, 2015 relate to a decrease in the operator estimate for abandonment of the Breagh development and to adjustments in the risk free interest rate (used for discounting).

	Nine months ended September 30, 2016	Twelve months ended December 31, 2015
	\$000s	\$000s
Balance, beginning of the period	36,841	55,564
Arising during the period	-	332
Obligation disposal	(660)	(2,409)
Revisions to estimates	5,106	(15,652)
Foreign exchange differences	(4,616)	(1,826)
Accretion of discount	360	832
Balance, end of the period	37,031	36,841

## **2016 PLANS**

#### In the UK:

- Move forward with preparation for the remainder of the Breagh Phase 1 project, specifically confirming well locations for the remaining wells and ensuring the onshore compression project is optimized for a low gas price environment;
- Continue to evaluate the potential for Breagh Phase 2 recognizing this will only occur if an economically viable development plan can be prepared;
- Continue with efforts to farm-out the UK licences containing the Niadar and Ossian/Darach prospects;
- To exit all other exploration and appraisal activities where the ongoing costs are not justified by the potential and timing of future exploration success;
- The Company will no longer consider acquisitions of North Sea assets; and
- Consider further reductions in ongoing G&A costs 2016 cost reduction initiatives have now been implemented.

## In the Netherlands:

• Achieve value for the Dutch contingent resources in blocks F17a/F18 via an asset sale or a joint regional development.

## Corporately:

• The Company will consider corporate transactions that are value accretive for shareholders and which would improve the credit-worthiness of the Group, as was intended prior to the Recapitalization.

Where appropriate, these plans remain contingent on partner approval, governmental approval and (if appropriate) farm-out partners or purchasers of licence interests or subsidiary companies.

#### RELATED PARTY AND OFF-BALANCE SHEET TRANSACTIONS

The Company had no off-balance sheet transactions in the nine month periods ended September 30, 2016 or 2015. In the nine month period ended September 30, 2016, £231,000 (\$314,000) was charged by a company called Corporate Development Partnership for the restructuring professional services of Andy Leeser, who was a director of the Company's UK subsidiary and sat as an observer on the board of the Company until October 21, 2016. John Rapach, a director of SHL, had an outstanding loan with the Company of £12,595 (\$16,920) carried forward from previous years but this was repaid in July, 2016. For the period until September 30, 2016 the Company had a GTSA with Vitol (which is a shareholder in the Company) signed in 2011 in relation to gas

produced from the Breagh field and as at September 30, 2016 the Company had a receivable of \$2,132,000 (December 31, 2015 – \$4,524,000) from Vitol for gas sold in September 2016, which was paid in October 2016. For a description of the key terms of the GTSA, see "Revenue". In addition, in January 2015, the Company purchased gas price put options for the second and third quarters of 2015 from Vitol (as well as from a third party) for a volume equivalent to 12 percent of production.

# **ADDITIONAL INFORMATION**

Additional information about Sterling Resources Ltd. and its business activities, including Sterling's Annual Information Form, is available via SEDAR at www.sedar.com.

# **CONDENSED CONSOLIDATED BALANCE SHEET**

As at	September 30, 2016	December 31, 2015
(Unaudited)	US\$000s	US\$000s
ASSETS		
Current assets		
Cash and cash equivalents (note 3)	7,658	10,889
Restricted cash	135	1,306
Trade and other receivables (note 4)	3,087	8,369
Inventory	704	325
Derivative financial asset (note 8)	251	-
Prepaid expenses	2,510	227
	14,345	21,116
Non-current assets		
Exploration and evaluation assets (note 6)	22,045	24,668
Property, plant and equipment (note 7)	267,706	341,029
Derivative financial asset (note 8)	1,515	, -
Repayment option on long-term debt (notes 8 & 10)	1,757	554
Deferred tax asset (note 19)	57,867	66,073
	350,890	432,324
	365,235	453,440
LIABILITIES AND EQUITY		
Current liabilities		
Trade and other payables	4,463	7,113
Decommissioning obligations (note 9)	, -	722
Accrued interest payable (note 10)	_	3,277
Current portion of long-term debt (note 10)	<del>-</del>	189,593
Cladhan funding arrangements (note 11)	7,601	21,358
	12,064	222,063
Non-current liabilities		
Decommissioning obligations (note 9)	37,031	36,119
Long-term debt (note 10)	40,861	-
Cladhan funding arrangements (note 11)	9,861	20,485
	87,753	56,604
Commitments and contingencies (note 12)	,	,
Equity		
Share capital (note 13)	595,741	427,440
Contributed surplus	19,818	19,552
Accumulated other comprehensive loss	(76,752)	(31,710)
Deficit	(273,389)	(240,509)
	265,418	174,773
	365,235	453,440

The accompanying notes are an integral part of the unaudited condensed interim consolidated financial statements as at and for the three and nine month periods ended September 30, 2016 ("the Financial Statements")

# **CONDENSED CONSOLIDATED INCOME STATEMENT**

	Three Months Ended September 30		Nine Months Ended	September 30
	2016	2015	2016	2015
(Unaudited)	US\$000s except per share		US\$000s ex	cept per share
Revenue (note 16)	11,704	19,335	36,560	61,842
Third-party entitlement (note 16)	(509)	(1,483)	(1,559)	(6,394)
	11,195	17,852	35,001	55,448
Expenses				
Operating expense	(3,269)	(4,322)	(9,253)	(13,794)
Pre-licence and other exploration expenditures	109	(125)	(951)	(7,691)
Impairment of oil and gas properties (note 7)	(2,739)	(9,776)	(17,724)	(10,158)
Depletion, depreciation and amortization (note 7)	(6,875)	(6,959)	(25,992)	(26,522)
Loss on derivative financial instruments (notes 8 & 10)	(152)	(411)	(1,048)	(2,226)
Loss on extinguishment of bond liability (note 10)	-	-	(4,686)	-
Re-measurement of Cladhan non-financial liability (note 11)	5,169	-	29,574	-
Employee expense (note 15)	(702)	(911)	(2,520)	(3,255)
General and administration expense	(911)	(500)	(1,603)	(2,136)
Refinancing and strategic review	(3,228)	(5,770)	(8,355)	(14,889)
Foreign exchange loss	(484)	(7,754)	(4,553)	(4,978)
Total expenses	(13,082)	(36,528)	(47,111)	(85,649)
Financing income	134	140	442	473
Financing costs (note 17)	(4,267)	(7,788)	(21,204)	(20,387)
Net financing cost	(4,133)	(7,648)	(20,762)	(19,914)
Loss on disposal	(4)	(924)	(8)	(964)
Loss before income taxes	(6,024)	(27,248)	(32,880)	(51,079)
Deferred tax income (note 19)	-	16,493	-	657
Net loss for the period	(6,024)	(10,755)	(32,880)	(50,422)
Net (loss) per common share (note 18)				
Basic	(0.04)	(0.03)	(0.11)	(0.13)
Diluted	(0.04)	(0.03)	(0.11)	(0.13)

The accompanying notes are an integral part of the Financial Statements.

# **CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
(Unaudited)	US\$000s	US\$000s	US\$000s	US\$000s
Net loss	(6,024)	(10,755)	(32,880)	(50,422)
Items that may be subsequently reclassified to profit and loss:				
Foreign currency translation adjustment	(10,527)	(11,520)	(45,042)	(10,429)
Comprehensive loss	(16,551)	(22,275)	(77,922)	(60,851)

The accompanying notes are an integral part of the Financial Statements.

# **CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**

			Accumulated Other		
	Share	Contributed	Comprehensive	Surplus /	
	Capital	Surplus	Loss	(deficit)	Total
(Unaudited)	US\$000s	US\$000s	US\$000s	US\$000s	US\$000s
Balance at January 1, 2015	419,940	18,877	(28,115)	(33,600)	377,102
Equity issuances (note 13)	7,500	-	-	-	7,500
Share-based compensation (note 15)	-	685	-	-	685
Foreign currency translation	-	-	(10,429)	-	(10,429)
Loss for the period	-	-	-	(50,422)	(50,422)
Balance at September 30, 2015	427,440	19,562	(38,544)	(84,022)	324,436
Balance at January 1, 2016	427,440	19,552	(31,710)	(240,509)	174,773
Equity issuances (note 13)	174,078	-	-	-	174,078
Share issue costs (note 13)	(5,777)	-	-	-	(5,777)
Share-based compensation (note 15)	-	266	-	-	266
Foreign currency translation	-	-	(45,042)	-	(45,042)
Loss for the period	-	-	-	(32,880)	(32,880)
Balance at September 30, 2016	595,741	19,818	(76,752)	(273,389)	265,418

The accompanying notes are an integral part of the Financial Statements.

# **CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Three Months Ended Sep 2016	tember 30 2015	Nine Months ended S <b>2016</b>	september 30 2015
(Unaudited)	US\$000s	US\$000s	US\$000s	US\$000s
Cash flows from operating activities				
Loss for the period	(6,024)	(10,755)	(32,880)	(50,422)
Adjustments for:				
Unrealized foreign exchange loss	736	150	8,563	1,303
Loss on disposal	4	960	8	964
Depletion, depreciation and amortization (note 7)	6,875	6,959	25,992	26,522
Impairment of oil and gas properties (note 7)	2,739	9,776	17,724	10,158
Unrealized loss on derivative financial instruments (notes 8 and 10	152	411	1,048	2,226
Loss on extinguishment of bond liability (note 10)	· -	_	4,686	, -
Re-measurement of Cladhan non-financial liability (note 11)	(5,169)	-	(29,574)	-
Share-based compensation (note 15)	(1)	84	266	685
Accretion of decommissioning discount (note 17)	116	323	360	871
Amortization of bond amendment costs (note 17)	426	7,521	426	9,522
Financing income	(134)	(140)	(442)	(473)
Interest expense (note 17)	3,725	4,366	20,418	19,516
Cladhan revenues foregone (note 16)	(2,840)	-	(8,260)	-
Deferred tax recovery (note 19)	-	(16,493)	-	(657)
	605	3,162	8,335	20,215
Change in non-cash working capital	(696)	(1,226)	349	(8,557)
Cash flows from operating activities	(91)	1,936	8,684	11,658
Cash flows from investing activities				
Proceeds from sale of assets (notes 5 & 6)	-	43,225	-	43,225
Exploration and evaluation asset additions	(88)	(1,019)	(445)	(1,317)
Property, plant and equipment additions	(381)	(2,056)	(3,024)	(7,675)
Cash flows (used in) provided by investing activities	(469)	40,150	(3,469)	34,233
Cash flows used in financing activities				
Decrease (increase) in restricted cash	(135)	-	1,171	(500)
Financing income	134	140	442	473
Bond interest payment	-	(675)	-	(9,788)
Bond amortization payment	-	(24,188)	-	(24,188)
Repayment of Gemini ORRI in Romania	-	(10,000)	-	(10,000)
Premium paid on derivative financial instruments (note 8)	-	_	(4,155)	(1,441)
Repayment of bond and associated costs from Rights Offering (note:	10) -	_	(990)	-
Proceeds from Rights Offering (note 10)	· -	_	990	-
Share issue costs (note 13)	-	_	(5,777)	-
Cash flows used in financing activities	(1)	(34,723)	(8,319)	(45,444)
		10		
Effect of translation on foreign currency cash and cash equivalents	42	(612)	(127)	(124)
(Decrease) increase in cash and cash equivalents during the period Cash and cash equivalents, beginning of the period	(519) 8,177	6,751 11,282	(3,231) 10,889	323 17,710
Cash and cash equivalents, end of the period	7,658	18,033	7,658	18,033

The accompanying notes are an integral part of the Financial Statements.

# NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

# (Unaudited)

As at and for the three and nine month periods ended September 30, 2016.

## 1) CORPORATE INFORMATION

Sterling Resources Ltd. (the "Company") is a publicly traded energy company incorporated and domiciled in Canada. The Company is engaged in the exploration, appraisal and development of crude oil and natural gas in the United Kingdom and the Netherlands. The Company's registered office is located at 4300 Bankers Hall West,  $888 - 3^{rd}$  Street SW, Calgary, Alberta, Canada.

The Company's consolidated financial statements comprise the financial statements of the Company and the wholly-owned group of companies: Sterling Resources (UK) Ltd ("Sterling UK"), SRUK Holdings Ltd, Sterling Resources Netherlands B.V., and up to the point of disposal Midia Resources SRL.

These unaudited condensed interim consolidated financial statements ("the Financial Statements") were approved for issuance by the Company's Board of Directors on November 22, 2016, on the recommendation of the Audit Committee.

## 2) BASIS OF PREPARATION

#### STATEMENT OF COMPLIANCE

These Financial statements were prepared in accordance with International Accounting Standard IAS 34, Interim Financial Reporting on a going-concern basis, under the historical cost convention except for the financial instruments that are measured at fair value at the end of each reporting period. They do not contain all disclosures required by International Financial Reporting Standards for annual financial statements and, accordingly, should be read in conjunction with the annual consolidated financial statements and notes thereto for the year ended December 31, 2015.

The presentation currency of these Financial Statements is the United States dollar.

## **BASIS OF CONSOLIDATION**

The Financial Statements comprise the financial statements of the Company and its subsidiaries as at September 30, 2016. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company's, using consistent accounting policies.

Substantially all of the Company's exploration activities are conducted jointly with others, including through farm-in and farm-out arrangements. These are classified as joint operations as they are not structured through separate legal vehicles. These Financial Statements include the Company's proportionate share of the assets, liabilities, revenue and expenses with items of a similar nature presented on a line-by-line basis, from the date the joint arrangement commences until it ceases.

Inter-company balances and transactions, and any unrealized gains arising from inter-company transactions with the Company's subsidiaries, are eliminated in preparing the Financial Statements.

#### 3) CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

As at	September 30, 2016	December 31, 2015
	\$000s	\$000s
Cash	7,658	1,160
Cash equivalents	-	9,729
	7,658	10,889
Balances held in:		
Canadian dollars	205	110
US dollars	3,777	9,003
UK pounds	3,210	1,742
Other	466	34
Cash and cash equivalents	7,658	10,889

As at September 30, 2016, cash and cash equivalents (including short term deposits) carried annual interest rates between 0.00 percent and 0.73 percent (December 31, 2015 – between 0.05 percent and 0.55 percent).

## 4) FINANCIAL INSTRUMENTS

The Company's financial instruments, including cash and cash equivalents, restricted cash, trade and other receivables, derivative financial instruments, trade and other payables and long-term debt have been categorized as follows:

- Cash and cash equivalents, restricted cash and derivative financial instruments held for trading;
- Trade and other receivables loans and receivables;
- Trade and other payables other financial liabilities; and
- Long-term debt other financial liabilities.

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's-length transaction between knowledgeable, willing parties who are under no compulsion to act. The fair value of derivative financial instruments is discussed in note 8. The fair value of the long-term debt is discussed in note 10.

The Company is exposed to various financial risks arising from normal-course business exposure as well as its use of financial instruments. These risks include market risks relating to foreign exchange rate fluctuations, commodity price risk and interest rate risk, as well as liquidity risk and credit risk as described below.

## **FOREIGN EXCHANGE RATE RISK**

The Company's functional currencies for the United Kingdom ("UK") and Netherlands, Canadian, and up until disposal, Romanian operations are the UK pound, Canadian dollar ("C\$") and United States ("US") dollar, respectively. Foreign exchange gains or losses can occur on translation of working capital denominated in currencies other than the functional currency of the jurisdiction which holds the working capital item. Excluding the impact of changes in the cross-rates, a 1 percent fluctuation in translation rates would have the following impact on net income or loss, based on foreign currency balances held at September 30, 2016.

	\$000s
Canadian dollar vs. UK pound	7
Canadian dollar vs. US dollar	3
UK pound vs. Euro	5
UK pound vs. US dollar	367

The effect of changes in the UK pound vs. US dollar exchange rate has increased as the Bond is denominated in US dollars, while the UK entity retains its functional currency as the UK pound.

#### **INTEREST RATE RISK**

From time to time, the Company may have significant cash or cash-equivalent balances invested at prevailing short-term interest rates. Accordingly, cash flows are sensitive to changes in interest rates on these investments. Based on total cash and cash equivalents and restricted cash at September 30, 2016, a 1 percentage point change in average interest rates over a nine month period would increase or decrease net income or loss by approximately \$58,000.

The interest rate charged under the Bond is currently fixed at 9 percent per annum. As these rates are fixed, the Company is not exposed to interest rate risk on its borrowings.

#### LIQUIDITY RISK

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with its financial liabilities.

The Company's liquidity position has been materially improved since December 31, 2015 by completion of the Recapitalization (see note 10) and previously by entering into the First Bond Amendments, Second Bond Amendments and Third Bond Amendments (see note 10), and certain other short term waivers and amendments to the Bond Agreement. As a result of the First Bond Amendments, the requirement to make a monthly transfer to the DSRA (defined hereinafter) at the end of November 2014 was cancelled. Pursuant to the Second Bond Amendments, the requirement to pay the April 2015 instalment to Bondholders was deferred until completion of the Romanian Sale in August 2015. The requirement to pay the October 2015 Instalment was postponed pursuant to the Third Bond Amendments. Finally, the Recapitalization resulted in the reduction of Bond Liabilities from \$214.3 million to \$40.3 million and the provision of up to \$40 million of new funding available in the form of the SSRCF (defined hereinafter). Pursuant to the Fourth Bond Amendments, Bond interest is payable in kind prior to cancellation of the SSRCF and no prepayments of the Bond are required prior to cancellation of the SSRCF. The Company expects to be able to refinance the SSRCF and the Bond prior to the SSRCF maturity date, possibly through a bank market reserves-based loan.

From October 1, 2016 to December 31, 2019, the Company has commitments amounting to approximately \$45 million (see note 12), of which \$36 million arises from UK exploration well drilling costs, with much smaller committed costs thereafter. The Company expects to be able to farm-down these exploration licences or seek further licence extensions so that it would not incur such costs in this time period. In addition, expected (but not committed) capital expenditures on the UK Breagh field over this same three and a quarter year period on the assumption of drilling wells A09 and A10 and installing onshore compression is expected to amount to approximately \$40 million, again with much smaller committed costs thereafter. The Company has modelled its expected future net cash flows (excluding the \$36 million of UK exploration well drilling costs) on the basis that the Company expects to be able to farm-down these exploration licences or seek further licence extensions so that it would not incur such costs through to the end of 2019. Through to April 2020 (the maturity date of the Bond) at recent forward curve prices, any usage of the SSRCF is expected to be minimal. Beyond this period, the Company expects cash balances to grow for several years. In this regard, in the Company's view, the key risks are interruptions to production from Breagh and lower than expected UK gas prices. The Company has mitigated the risk of the former by insuring for loss of production income and has mitigated the risk of the latter through gas price hedging. Taken together with these intended mitigation measures, the Company expects the availability of up to \$40 million of additional funding from the SSRCF to provide sufficient headroom to meet all reasonable downside scenarios of operating and financial performance. Consequently, the Directors are satisfied that the Company should be able to continue as a going concern for the foreseeable future.

#### **COMMODITY PRICE RISK**

The Company is exposed to the risk of commodity price fluctuations on its future natural gas production. For Breagh, the Company will sell gas produced at a price linked to the UK spot market, which is a liquid market. The Company's policy is to manage downside price risk in support of debt service obligations, through the use of derivative commodity contracts. In January 2015, the Company purchased monthly cash-settled UK gas price put options for the second and third quarters of 2015 at a strike price of 40 pence per therm (National Balancing Point "NBP") for a volume equivalent to 4.0 Bcf of gas, or approximately 75 percent of expected production for the period and have now expired. The put options were purchased from BNP Paribas and Vitol SA for a total consideration of approximately \$1.4 million.

In the second quarter of 2016, the Company purchased monthly cash-settled UK gas price put options from BNP Paribas and Citigroup to cover a proportion of the Company's expected production for a total consideration of approximately \$4.2 million. Unexpired options are as follows:

Period	Strike price, UK pence/therm	Hedge amount, million therms	Approximate production proportion hedged
Q4 2016	34.0	13.1	75%
Q1 2017	34.0	11.7	75%
Q2 2017	31.0	9.9	75%
Q3 2017	31.0	12.3	75%
Q4 2017	34.0	15.3	75%
Q1 2018	34.0	12.6	51%
Q2 2018	31.0	11.7	51%
Q3 2018	31.0	10.8	50%
Q4 2018	34.0	16.2	49%
Total		113.6	61%

The approximate production proportion hedged is based on the Company's proved plus probable production profile assuming a drilling rig start on wells A09 and A10 and the hydraulic stimulation of an existing well commencing in April 2017 and onshore compression coming online in October 2017. The Company intends to review its hedging program regularly in consultation with the Senior Lenders (see note 10).

#### **CREDIT RISK**

Credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss to the Company. The Company's trade and other receivables are primarily (i) for gas sold in one month and paid in the following month and (ii) with joint venture partners in the oil and natural gas industry. Up until the September 30, 2016, the Company sold its gas to only one customer Vitol (which is a shareholder in the Company). At September 30, 2016, the amount receivable from Vitol was \$2,132,000, which was paid within the following month and the Company had no other material concentrations of receivables with any third party.

On September 8, 2016 the Company announced that it had entered into a gas sales agreement with British Gas Trading Limited ("BGT"), a subsidiary of Centrica plc. The agreement provides for Sterling's share of Breagh nominated gas volumes to be sold on a day ahead basis to the UK reference price at the National Balancing Point ("NBP"). The agreement is valid for a minimum two year period with gas made available to BGT commencing October 1, 2016. The agreement replaces the gas trading and services agreement with Vitol SA which expired on October 1, 2016.

Impairment to a financial asset is only recorded when there is objective evidence of impairment and the loss event has an impact on future cash flow and can be reliably estimated. Evidence of impairment may include default or delinquency by a debtor or indicators that the debtor may enter bankruptcy. Where aged debtors are present, these are secured by the partner's interest in the underlying oil and gas properties the value of which exceeds any debts.

The Company's receivables are subject to normal industry risk and management believes collection risk is minimal. There were no material amounts past due but not impaired at September 30, 2016 (December 31, 2015 - nil).

The Company has deposited its cash, cash equivalents and restricted cash with reputable financial institutions, with which management believes the risk of loss to be remote. The maximum credit exposure associated with financial assets is their carrying value. At September 30, 2016 the cash, cash equivalents and restricted cash were held with four different institutions from four countries, mitigating the credit risk of a collapse of one particular bank.

# **CAPITAL MANAGEMENT**

The primary objective of the Company's capital management is to ensure sufficient funds are available for operational purposes while retaining flexibility to cope with adverse movements in production rates, commodity prices and interest rates. In addition, at all times the Company is required to comply with the terms of its Bond which includes a variety of financial covenants (see note 10). As such, the Company considers working capital, debt and equity as part of its capital management planning. The Company's capital management should be read in conjunction with the Liquidity Risk section of this note. The Company's capital management objectives, policies or processes were revised during the current year to reflect the new requirements of the Bond and SSRCF. The previous objective of having a capital structure broadly comparable with the Company's peer group is no longer considered appropriate.

The Company assesses its capital structure on a forward-looking basis by modelling net cash flows over the next few years and considering the economic conditions and operational factors which could lead to financial stress.

## 5) ROMANIAN SALE

On August 26, 2015, the Company completed the sale of its remaining Romanian business (the "Romanian Sale") to Carlyle International Energy Partners ("Carlyle"). The sale included licence blocks 13 Pelican, 15 Midia and 25 Luceafarul, structured as a corporate sale of the Company's wholly-owned subsidiary Midia Resources SRL and was first announced on March 26, 2015.

The headline consideration for the transaction was \$42.5 million. In addition, Carlyle also reimbursed Sterling approximately \$1.4 million in costs incurred by Midia Resources SRL between signing and completion ("Interim Period Costs"), of which half was paid on completion and the other half (subject to adjustments) was paid as a post completion settlement in December 2015. Sterling received an initial cash payment of approximately \$40.5 million from Carlyle, which is \$42.5 million less an amount withheld on account of Romanian VAT of approximately \$2.7 million plus approximately \$0.7 million as half of the Interim Period Costs. Subsequent to completion, Sterling filed a quarterly return, subject to future tax audit, for Romanian corporate tax in October 2015 showing an overall net capital loss and hence no corporate tax liability arising from the transaction (after taking into account the availability of tax deductible past costs and losses). The VAT amount with minor adjustments was refunded to Sterling in March 2016, together with a refund of \$0.8 million relating to past costs unrelated to the Romanian Sale. No Canadian corporate tax is expected to be payable as a result of available tax deductions.

Concurrent with the Romanian Sale, Sterling terminated the investment agreement signed with Gemini in 2007 for a cash consideration of \$10 million (the "Gemini Cash Payment") and the issuance to Gemini of 60,372,876 common shares of Sterling ("Common Shares") with a market value of \$7.5 million. Net of the Gemini Cash Payment, transaction-related taxes and reimbursement to Sterling of allowable transaction fees already paid, an initial amount of approximately \$27.4 million out of the Romanian Sale proceeds was applied pursuant to the cash waterfall provisions of the Bond Agreement (see note 10). \$24.8 million of this amount was used to pay Bondholders the outstanding amortization instalment which had been due on April 30, 2015, together with 7.5 percent amortization premium and accrued interest, and the remaining \$2.6 million was transferred to the restricted Debt Service Retention Account ("DSRA") and was used subsequently towards funding the next interest payment due to Bondholders on October 30, 2015. Because the sale closed more than two months after July 15, 2015, Sterling made two payments to Bondholders each of \$0.75 million, in accordance with the Bond Agreement.

## 6) EXPLORATION AND EVALUATION ASSETS ("E&E")

Minimal amounts have been capitalized to E&E assets during the nine month period ending September 30, 2016.

No E&E assets have been impaired in the nine month period ending September 30, 2016, however impairment costs in the year ending December 31, 2015 related to:

- Following the completion of the economic valuation of UK block 21/30f containing the Belinda discovery in the third quarter of 2015, Sterling elected to withdraw from the licence resulting in an impairment of previously capitalized costs of \$1,279,000.
- On August 26, 2015 the Company completed the sale of its remaining Romanian business (see note 5) resulting in a disposal of E&E assets of \$25 million.

Movements in the balances of E&E assets are summarized below:

As at	September 30, 2016	December 31, 2015	
	\$000s	\$000s	
Balance, beginning of the period	24,668	51,844	
E&E expenditures	408	413	
Non-cash decommissioning costs (note 9)	52	11	
Disposal of assets	-	(25,000)	
Impairment	-	(1,279)	
Foreign exchange	(3,083)	(1,321)	
Balance, end of the period	22,045	24,668	

## 7) PROPERTY, PLANT AND EQUIPMENT ("PP&E")

Development oil and gas properties are assessed for indicators of impairment at each reporting date.

Due to cost and time overruns on the Cladhan UK offshore property, poorer than expected production and the drop in worldwide commodity prices, under RPS, the Company's reserve auditors, pricing assumptions pay-out of the entire amount of the Second Carry (see note 11) is not now likely to occur and the liability has been re-measured to reflect the amount most likely to be repaid from future revenues of the 11.8 percent of the development being funded by TAQA. Under these same criteria it is unlikely that the 11.8 percent asset will return to the Company and the remaining asset represents the amount of the revenues expected to be earned that will go to reduce the Second Carry. At September 30, 2016, after comparison of the carrying value and its fair value the property has been impaired by \$15,718,000 during the year. The recoverable amounts were based on the value in use method and were determined at the level of the cash generating unit determined to be the Cladhan development oil and gas property. The recoverable amounts were based on discounted future cash flows over the next eight years, derived using proved plus probable reserves as at September 30, 2016. The cash flows (based on level III fair value hierarchy) used commodity prices based on RPS Energy's reserves report and a pre-tax discount rate of 17 percent. In addition, the Company's wholly owned 2 percent of the field has been impaired by \$2,006,000 as at September 30, 2016 based on the same criteria above but using a pre-tax discount rate of 10 percent (the rate the Company's uses for net present value investment decisions). This followed impairments on the Cladhan asset in the year ending December 31, 2015 of \$38,099,000.

On September 29, 2016 the Company disposed of its previously fully written down Kirkleatham UK onshore asset and the asset and accumulated depletion have been removed from the calculations below.

Depletion on the Breagh and Cladhan assets commenced with first production on October 12, 2013 and December 15, 2015, respectively.

As at	September 30, 2016			December 31, 2015		
	Development Oil & Gas Properties	Corporate And Other	Total	Development Oil & Gas Properties	Corporate And Other	Tota
	\$000s	\$000s	\$000s	\$000s	\$000s	\$000
Cost						
Balance, beginning of the period	469,696	1,227	470,923	457,628	1,565	459,193
Additions						
– PP&E expenditures	6,850	-	6,850	47,346	2	47,348
<ul> <li>Non-cash decommissioning costs (note 9)</li> </ul>	5,054	-	5,054	(15,331)	-	(15,331)
Disposals	(6,748)	(263)	(7,011)	-	(256)	(256)
Foreign exchange differences	(41,495)	(49)	(41,544)	(19,947)	(84)	(20,031)
Balance, end of the period	433,357	915	434,272	469,696	1,227	470,923
Accumulated depreciation and depletion						
Balance, beginning of the period	(128,940)	(954)	(129,894)	(58,991)	(1,098)	(60,089)
Depreciation and depletion	(25,922)	(70)	(25,992)	(36,460)	(116)	(36,576)
Impairment	(17,724)	-	(17,724)	(38,099)	-	(38,099)
Disposals	6,748	263	7,011	-	189	189
Foreign exchange differences	15	18	33	4,610	71	4,681
Balance, end of the period	(165,823)	(743)	(166,566)	(128,940)	(954)	(129,894)
Net book value						
Balance, beginning of the period	340,756	273	341,029	398,637	467	399,104
Balance, end of the period	267,534	172	267,706	340,756	273	341,029

#### 8) DERIVATIVE FINANCIAL INSTRUMENTS

The original fair value of the repayment option on the Bond was determined to be \$5,861,000. On May 30, 2016 following the Recapitalization (see note 10) changes in the terms of the Bond led to this option being derecognized and a new fair value of the repayment option was determined to be \$819,000. This was subsequently revalued at September 30, 2016, to be \$1,757,000. The call option on the Bond was valued using the Black-Karasinski model which takes into account interest rate volatility. Key inputs used in the model were related to the credit spread of the Company and the United States dollar discount curve. In the nine month period ended September 30, 2015, a gain on the revaluation of the repayment option on the Bond of \$1,341,000 was recognized.

In the second quarter of 2016, the Company purchased monthly cash-settled UK gas price put options from BNP Paribas and Citigroup to cover a proportion of the Company's expected production for a total consideration of \$4,155,000 (see note 4). The derivatives are revalued to their fair value at each period end. Any gain or loss is recorded through the income statement in the period in which it arose. At September 30, 2016 the derivatives were valued at \$1,766,000, \$251,000 recorded as a current asset as they will mature within the next twelve months and \$1,515,000 as a non-current asset. For the nine month period ended September 30, 2016, the Company recognized an unrealized loss of \$2,389,000.

In January 2015, the Company purchased monthly cash-settled UK gas price put options for the second and third quarters of 2015 at a strike price of 40 pence per therm (at National Balancing Point in the UK) for a volume equivalent to 4.0 Bcf of gas, or approximately 75 percent of expected production for that period, which have now expired. The put options were purchased from BNP Paribas and Vitol for a total consideration of approximately \$1.4 million. For the nine month period ended September 30, 2015, the Company recognized an unrealized loss of \$1,400,000.

For the nine month period ended September 30, 2016, the Company recognized an unrealized loss of \$1,048,000 on the combined movements in derivative financial instruments, compared to an unrealized loss on \$2,226,000 in the nine month period ended September 30, 2015.

#### 9) DECOMMISSIONING OBLIGATIONS

The following table sets out a continuity of decommissioning obligations:

As at	September 30, 2016	December 31, 2015
	\$000s	\$000s
Balance, beginning of the year	36,841	55,564
Arising during the year	-	332
Obligation disposal	(660)	(2,409)
Revisions to estimates	5,106	(15,652)
Foreign exchange differences	(4,616)	(1,826)
Accretion of decommissioning discount (note 17)	360	832
Balance, end of the year	37,031	36,841
Total current liabilities	-	722
Total non-current liabilities	37,031	36,119

The Company's decommissioning obligations result from net ownership interests in petroleum and natural gas interests in which there has been exploration, appraisal and development activity. The provision is the discounted present value of the estimated cost, using existing technology at current prices. The Company estimates the total undiscounted amount of cash flows required to settle its decommissioning obligations as at September 30, 2016 to be approximately \$45,776,000, which will be incurred between 2016 and 2036. Two wells on the Sheryl licence were abandoned during the third quarter of 2016 and this portion of the decommissioning obligation, \$660,000, previously recognized as a current liability has been derecognized. Risk free interest rates based on UK long-term government bond rates varying from 0.77 percent to 1.57 percent (December 31, 2015 – 1.37 to 2.39 percent) and an inflation rate of 2 percent (December 31, 2015 – 2 percent) were used to calculate the longer term decommissioning obligations at September 30, 2016. The reduction in the interest rates resulted in a revision to the decommissioning obligation estimates of \$5,106,000 in the nine months ended September 30, 2016. During the year ended December 31, 2015 the Company sold its Romanian business including all decommissioning obligations resulting in an obligation disposal of \$2,354,000 and completed the non-operational abandonment of the Grenade well in France resulting in a further obligation disposal of \$55,000. Decommissioning obligations arising in the year ended December 31, 2015 relate to facilities

related to the Cladhan development. Decommissioning estimates for the Cladhan development are currently calculated at an equity percentage of 2 percent, but may rise to 13.8 percent in the event of repayment of the Cladhan funding arrangements (See note 11). Revisions to estimates in the year ended December 31, 2015 relate to a decrease in the operator estimate for abandonment of the Breagh development and to adjustments in the risk free interest rate (used for discounting).

# 10) LONG-TERM DEBT

## **RECAPITALIZATION**

On May 30, 2016 (the "Recap Closing Date"), the Group completed a recapitalization (the "Recapitalization") pursuant to a recapitalization agreement (the "Recapitalization Agreement") involving the Company, its subsidiary, Sterling Resources (UK) Ltd. ("SRUK") and Nordic Trustee ASA (the "Bond Trustee") in relation to the senior secured bond (the "Bond") issued by SRUK pursuant to a bond agreement originally dated May 2, 2013, as subsequently amended (the "Bond Agreement"). The Recapitalization was required as a result of the Company and SRUK being unable to implement a financing, asset/corporate sale or merger transaction by February 29, 2016 as required by the Third Bond Amendments (as defined below). The principal elements of the Recapitalization were a rights offering, a bond exchange, an internal transfer of SRUK, further amendments to the terms of the remaining Bonds, provision of new funding via a super senior revolving credit facility and certain other actions all as described below.

(i) **Rights Offering.** The Company conducted a rights offering (the "Rights Offering") by way of short form prospectus to the holders of its Common Shares on the record date of April 27, 2016 pursuant to which eligible shareholders received rights entitling them to purchase an aggregate of 14,277,525,577 Common Shares at a subscription price per Common Share of Canadian Dollar ("C\$") 0.015398 (the "Subscription Price"). The Rights Offering closed on May 30, 2016 and raised proceeds of C\$1,303,647 for the issuance of 84,663,364 Common Shares.

The gross proceeds of the Rights Offering, after such funds were converted to US dollars and less a foreign exchange adjustment, of \$989,860.65 (the "Rights Offering Proceeds"), were used solely to fund the release and cancellation of a portion of the liabilities of the Company and SRUK under or in connection with the Bonds, comprising principal, redemption premium, accrued (but unpaid) amendment fees and interest (the aggregate of all such liabilities being the "Bond Liabilities" and the amount so released and cancelled with the Rights Offering Proceeds being the "Purchased Liabilities"). The expenses associated with the Rights Offering were paid from the general funds of the Company.

(ii) Bond Exchange. The Bondholders (as defined herein) (directly, or indirectly through an affiliate, or through the Bond Trustee) subscribed for the unsubscribed 14,192,862,213 Common Shares under the Rights Offering (the "Exchange Shares") at the same price per Common Share as the Rights Offering Subscription Price. The value of the Exchange Shares, converted to US dollars on the date of the final prospectus, amounted to \$173,088,621 (the "Exchange Amount"). The consideration for the Exchange Shares was, indirectly, the full and final satisfaction of Bond Liabilities equal to the Exchange Amount (the "Exchanged Bond Liabilities").

Immediately prior to the Recap Closing Date, the Bond Liabilities amounted to \$214,340,000. After the release/cancellation of Purchased Liabilities and the Exchanged Liabilities, the remaining Bond Liabilities immediately after the Recap Closing Date were \$40,261,519, all in the form of Bond principal (the "Remaining Bonds").

As a result of the Bond Exchange and the issuance of Common Shares pursuant to the Rights Offering, the aggregate equity held by the holders of Common Shares prior to the Recapitalization was diluted to approximately 3.58 percent of the total equity of the Company after completion of the Recapitalization. Bondholders acquired Common Shares aggregating to approximately 96.4 percent of the Common Shares after completion of the Recapitalization.

- (iii) **Transfer of SRUK.** On the Recap Closing Date, the Company transferred the entire share capital of SRUK to a new wholly-owned subsidiary governed by the laws of England and Wales, SRUK Holdings Ltd. ("SHL"), in order to provide additional security to Bondholders and lenders under the SSRCF (as defined below) and greater flexibility in any future refinancing of the SSRCF and the Bonds post-Recapitalization.
- (iv) Remaining Bonds. On the Recap Closing Date, SRUK and the Company entered into a further amended and restated Bond Agreement with the Bond Trustee (the "Fourth Bond Amendment Agreement") for the purpose of setting out the revised terms and conditions governing the Remaining Bonds, as described below under "Bond". The amount of the Remaining Bonds was approximately \$40.3 million as at May 30, 2016, as described under "Bond Exchange" above.

- (v) Super senior revolving credit facility. On the Recap Closing Date, the Company and SRUK entered into an agreement for a new loan with two of the Bondholders or their affiliates (the "Senior Lenders") as described under "Super Senior Revolving Credit Facility" below.
- (vi) Other actions. A number of further agreements and actions were provided for in the Recapitalization Agreement. On the Recap Closing Date, the Company and SRUK also entered into an intercreditor agreement (the "Intercreditor Agreement") with the Senior Lenders and the Bondholders. Each of the Company and its affiliates (including SHL) also executed the guarantees and security documents contemplated in the Fourth Bond Amendment Agreement and the Super Senior Revolving Credit Facility. An Exit Fee (as defined herein) letter entered into between the Company and the Bond Trustee pursuant to the Amendment and Restatement Agreement No. 3 (as described in the Company's news release of October 22, 2015) was terminated on the Recap Closing Date. Pursuant to the Recapitalization Agreement, shortly after the Recap Closing Date, the Company conducted its annual and special meeting of shareholders held on July 5, 2016, at which was passed, among other things: (a) a resolution approving the creation of a new "Control Person" (as defined in TSX Venture Exchange ("TSXV") Policy 1.1 Interpretation) created as a result of the Bond Exchange; and (b) a special resolution approving the 100:1 Consolidation of the Common Shares.

### SUPER SENIOR REVOLVING CREDIT FACILITY

On the Recap Closing Date, the Company and SRUK entered into an agreement for a new loan with two of the Bondholders or their affiliates (the "Senior Lenders") in the form of a super senior revolving credit facility (the "SSRCF") of up to \$40 million. The SSRCF comprises two tranches, A and B, each of \$20 million and both on a revolving, multi-currency basis. Tranche A is to be used first, up to \$10 million for general corporate purposes and for capital expenditures in accordance with the relevant annual budget. Tranche B, if required, is for capital expenditures only in accordance with the relevant annual budget. The final maturity date is 24 months after the Recap Closing Date, with an optional extension to April 30, 2019 subject to satisfying certain conditions. There is a 7 percent arrangement fee on each Tranche, for Tranche A paid in cash on the Recap Closing Date and for Tranche B to be paid in cash upon the earlier of the date of first utilization of Tranche B and the date falling 24 months after the Recap Closing Date (provided that no fee shall be payable if the SSRCF is cancelled in full before that date).

The interest rate for each tranche is the aggregate of the margin and LIBOR (subject to a LIBOR floor of 1 percent). The margin for Tranche A is 13 percent per annum, and for Tranche B 13 percent per annum increasing 100 basis points each quarter from drawdown of Tranche B (subject to an overall cap of 15 percent per annum). Interest is calculated from the date of utilization of each Tranche until the date the relevant Tranche is repaid, prepaid or cancelled, and paid semi-annually on 30 April and 30 October. Tranche A interest is paid in cash and Tranche B interest is paid in kind (i.e. added to the principal amount). There is a commitment fee on the unused part of each tranche equal to half of the applicable margin, paid on each interest payment date; for Tranche A paid in cash and for Tranche B, paid in kind but only if Tranche B is utilized. There is a cancellation premium on Tranche A and (if used) Tranche B, equal to the relevant commitment fee on the cancelled amount calculated from the date of cancellation to the applicable final maturity date.

Financial covenants are essentially the same as those applying for the Remaining Bonds (save for those financial covenants which only apply from the discharge date of the SSRCF) and in addition there are utilization conditions which comprise, on a simplified basis: (i) a minimum interest cover ratio (EBITDA to SSRCF cash charges) of 1.0x, (ii) a minimum 4-year Rolling Net Present Value cover ratio of 1.3x, (iii) a minimum group cash requirement of \$5 million on a projected basis until the SSRCF discharge date and (iv) ) in relation to a Tranche B utilization only, a minimum field life cover ratio of 1.75x. The SSRCF will have senior ranking in relation to guarantees and security package as described under the Bond, as set out in the Intercreditor Agreement.

As of September 30, 2016, the balance of the SSRCF was zero and from the Recap Closing Date through to the date of this report the SSRCF has not been utilized.

### **BOND**

In April 2013, SRUK (the "Issuer") completed the issuance of the Bond, which is listed on the Nordic Alternative Bond Market in Oslo (under the ticker STRE01 PRO) but not actively traded. The Bond Agreement has been amended and restated as a result of four sets of amendments approved by holders of the Bond ("Bondholders"), firstly in December 2014 (the "First Bond Amendments"), secondly in May 2015 (the "Second Bond Amendments"), thirdly in November 2015 (the "Third Bond Amendments") and fourthly in May 2016 (the "Fourth Bond Amendments"). These four sets of amendments led to the entry into the Amended and Restated Bond Agreements No. 1, 2, 3 and 4, respectively.

The Bond is governed by Norwegian Law and the trustee for the Bond is Nordic Trustee ASA (formerly Norsk Tillitsmann ASA; the "Bond Trustee"). Note SRUK has changed its legal form twice (for tax and security related considerations), from a limited company at the time of the original Bond issue to a public limited company and, in January 2016, back to a limited company.

The Bond was originally set to mature on April 30, 2019 but pursuant to the Fourth Bond Amendments this has been extended to April 30, 2020. At the time of issuance, the Bond carried an interest coupon of 9 percent payable in cash semi-annually on April 30 and October 30 of each year. Pursuant to the Second Bond Amendments the coupon was increased to 14 percent per annum (paid in cash) as from October 30, 2015 and pursuant to the Fourth Bond Amendments, the coupon dropped back to 9 percent per annum calculated from the Recap Closing Date and will be paid in kind until the date the SSRCF is repaid, prepaid or cancelled (the "SSRCF Discharge Date") and thereafter paid in cash. To the date of this report, all interest payments have been paid in full when due.

At the time of issue, the Bond was callable (prepayable) at the option of SRUK at any time with a call price of 105 percent of par value for the first three years (with a roll-up of outstanding interest for the first two years), a call price of 103.5 percent of par value in year four, 102 percent in year five, and finally 101 percent and 100.5 percent for the first and second halves of the final year. Pursuant to the Second Bond Amendments, the call price was set at 107.5 percent of par value from May 1, 2015 until maturity. Pursuant to the Fourth Bond Amendments, the call price has been decreased to par value from the Recap Closing Date until maturity.

Commencing on October 30, 2014, the Bond began to amortize 10 percent of the issue amount every six months. At the time of issue, the amortization instalments were due to be performed at a price of 105 percent of par value except for the final instalment which would be repaid at 100 percent of par value. Pursuant to the Second Bond Amendments, the amortization price has been set at 107.5 percent of par value for all instalments from April 30, 2015 onwards. In order to avoid a potential payment default, the amortization instalment due on April 30, 2015 (the "April 2015 Instalment") was deferred until the closing of the Romanian Sale (as defined herein) on August 26, 2015, in accordance with the Second Bond Amendments. For the same reason, the amortization instalment due on October 30, 2015 (the "October 2015 Instalment") was deferred pursuant to the Third Bond Amendments until the earlier of (i) completion of a financing, corporate sale, or asset sale transaction leading to a full redemption of the outstanding Bonds (including the 7.5 percent call premium, and accrued interest and other related costs), or (ii) February 29, 2016. As a result of the two instalments paid on October 30, 2014 and on August 26, 2015, the outstanding Bond principal immediately prior to the Recapitalization was \$180 million. Pursuant to the Recapitalization Agreement, immediately after the Recap Closing Date the principal amount of the Remaining Bonds was reduced to \$40,261,519 (as described under "Bond Exchange" above) with no associated accrued and unpaid redemption premium, amendment fees or interest. Repayment will occur via a cash sweep (subject to various tests) after the SSRCF Discharge Date with any final balance under the SSRCF repayable as a single sum on maturity.

Pursuant to the original Bond Agreement, on the 30<sup>th</sup> day of each month from October 2013, a sum equal to one sixth of the sum of the next semi-annual interest payment and debt amortization payment was to be made to the Debt Service Retention Account ("DSRA") (such transfers being the "Monthly Transfers"). The DSRA is charged and blocked in favour of the Bond Trustee. Pursuant to the First and Second Bond Amendments, no Monthly Transfers were made from November 2014 until October 2015 inclusive and pursuant to the Third Bond Amendments, the requirement for Monthly Transfers was deleted. Pursuant to the Fourth Bond Amendments, the Monthly Transfers have been reinstated such that the first Monthly Transfer will be made in the month following the SSRCF Discharge Date.

There is a wide-ranging guarantee and security package in favour of the Bondholders and, from the Recap Closing Date, in favour of the Senior Lenders. The security agent is now GLAS Trust Corporation Limited acting on behalf of the Bondholders and the Senior Lenders. The Senior Lenders have a senior ranking for the purposes of the guarantee and security as set out in the Intercreditor Agreement. Guarantees are provided by the Company, SHL and SRUK. The security package includes a charge over the Issuer's interests in the Breagh and Cladhan fields, charges over the shares of SHL and SRUK and pledges over certain bank accounts. An additional security agreement providing an assignment of certain of the Company's receivables relating to a sale of part of a Romanian licence to ExxonMobil and other parties in 2012 is no longer in effect following a relinquishment of the relevant licence by ExxonMobil and its partners as of August 4, 2016.

Net proceeds from the Romanian Sale received in August 2015 of approximately \$27.4 million (being gross proceeds less a cash payment to Gemini, transaction-related taxes and reimbursement to Sterling of allowable transaction fees already paid; see "Romanian Sale") were applied pursuant to the cash waterfall provisions set out in the Second Bond Amendments. \$24.8 million of this amount was used to pay Bondholders the outstanding April 2015 Instalment (together with 7.5 percent amortization premium and accrued interest) and the remaining \$2.6 million was transferred to the DSRA and was used towards funding the interest payment made on October 30, 2015. Further transfers to the DSRA resulting from the application of the cash waterfall were made upon the post completion settlement of the Romanian Sale and following the receipt of a refund of Romanian VAT.

Prior to the Fourth Bond Amendments there were two financial covenants under the Bond Agreement: first, SRUK was required to maintain at all times a minimum level of liquidity (unrestricted cash and cash equivalents) of \$10 million and secondly, at the consolidated group level, the Company was required to maintain at all times a minimum equity ratio of 40 percent (defined as total Equity divided by total Assets calculated in accordance with IFRS). Pursuant to the First Bond Amendments, the minimum UK liquidity was reduced on a temporary basis to \$7.5 million from November 30, 2014 to January 30, 2015 and to \$10 million from January 31, 2015 onwards. Pursuant to the Second Bond Amendments, the minimum UK liquidity was reduced to \$5 million from October 31, 2015 onwards. Pursuant to the Third Bond Amendments, the minimum UK liquidity was kept at \$5 million from October 30, 2015 to November 29, 2015, and increased to \$7.5 million from November 30, 2015 to February 28, 2016. The minimum UK liquidity was kept at \$7.5 million pursuant to an amendment letter dated February 29, 2016 and was reduced to \$5 million from March 18, 2016 pursuant to an amendment approved at a Bondholder meeting on that date. Pursuant to the Fourth Bond Amendments, from the Recap Closing Date further changes to the financial covenants became effective, as follows:

- i) a minimum liquidity requirement is calculated at a level of \$5 million for the Company and its subsidiaries (collectively, the "Group") until maturity, to be satisfied at all times;
- ii) the minimum equity ratio requirement is deleted;
- iii) a minimum field life cover ratio (corporate net present value divided by total SSRCF debt) of 1.5x, dropping to 1.0x after the date the SSRCF Discharge Date, to be tested at the end of each quarter and upon certain other events;
- iv) cumulative production for the previous 12 months (or a shorter period during 2016) of not less than 90% of the budgeted amount, to be tested at the end of each month;
- v) projected liquidity of \$5 million (on a Group basis) until the Bond maturity date (excluding in any such projection the repayment of the Bond on maturity), to be tested at the end of each quarter after the SSRCF Discharge Date; and
- vi) a minimum debt service cover ratio of 1.0x, calculated over the previous 12 months (or a shorter period during 2016), to be tested at the end of each quarter from the end of the second quarter after the SSRCF Discharge Date.

FTI Consulting, a financial adviser, was appointed by the Bond Trustee in April 2015 at Sterling's cost to review the Company's assets, cash flows and sale/financing initiatives in support of the Second Bond Amendments. In addition, pursuant to the Second Bond Amendments, Sterling appointed Jefferies International in July 2015 as its strategic financial adviser to assist the Company in the assessment and implementation of strategic options available to it, including a sale of all or part of its assets.

Pursuant to the First Bond Amendments, an amendment fee of \$2.5 million was paid to bondholders in December 2014. Pursuant to the Second Bond Amendments, an amendment fee of \$3 million was paid to Bondholders in May 2015 and two further amendment fees, each of \$750,000, were paid to Bondholders in July and August 2015 as a result of completion of the Romanian Sale being delayed beyond July 15, 2015. Pursuant to the Third Bond Amendments, an initial amendment fee of \$1 million was paid to Bondholders in November 2015 and additional amendment fees of \$6 million were due within five business days of February 29, 2016 as a result of the Bond not having been redeemed by that date. Pursuant to the Recapitalization Agreement, the aggregate additional amendment fees of \$6 million were included in the Bond Liabilities cancelled as a result of subscriptions received in the Rights Offering or exchanged into new Common Shares as a result of the Bond Exchange.

The Third Bond Amendments also included the introduction of a potential "Exit Fee" which may have been payable after bond redemption, being effectively 20 percent of the incremental final (post bond redemption) equity value above a 100 percent increase on the initial equity value (measured prior to approval of the Third Bond Amendments), payable in cash and/or common shares in Sterling Resources Ltd. and subject to certain adjustments and conditions. The requirement for this Exit Fee was cancelled from the Recap Closing Date, pursuant to the Recapitalization Agreement. In addition, the Third Bond Amendments required the appointment of an Independent Director to the board of directors of the Company (subsequently amended to the appointment of a board observer) and SRUK, as nominated by the Bond Trustee.

As at September 30, 2016 and to the date of this report, the Company was in compliance with the terms of the Bond (as amended and with waivers provided by Bondholders).

As the Bond is not actively traded on the Nordic Alternative Bond Market in Oslo, a value based on the mid-point of the bid/ask price range supplied by Pareto Securities AS, the principal broker for the Company's bonds, was used to calculate the fair value of the Bond of \$35 million as at September 30, 2016, reduced following the Recapitalization.

The original fair value of the prepayment option on the Settlement Date was determined to be \$5,861,000. On May 30, 2016, following the Recapitalization changes in the terms of the bond led to this option being de-recognized and a new fair value of the prepayment option was determined to be \$819,000. This was subsequently revalued at September 30, 2016 to be \$1,757,000. The call option on the bond was valued using the Black-Karasinski model which takes into account interest rate volatility. Key inputs used in the model were related to the credit spread of the Company and the United States dollar discount curve.

The following table sets out a continuity of long-term debt:

As at	September 30, 2016	
	\$000s	\$000s
Balance, beginning of the period	189,593	207,670
Amortization of loan funds	(139,948)	(24,188)
Borrowing costs	1,947	7,625
De-recognition of embedded derivative	(5,861)	-
Recognition of embedded derivative	819	-
Accretion of discount	(5,689)	(1,514)
Balance, end of the period	40,861	189,593

### 11) CLADHAN FUNDING ARRANGEMENTS

In April 2013, the Company signed agreements with TAQA Bratani ("TAQA") which ensured that the Company was in a position, regardless of the closing of the then contemplated Bond, to submit evidence of funding ability for its share of the development costs of Cladhan to the UK Department of Energy and Climate Change by April 17, 2013 to enable field development plan approval. In conjunction with an earlier non-repayable carry arising from a transaction with TAQA in 2012 (the "First Carry"), these agreements also provided for a full carry of the then anticipated development capital costs until first oil, anticipated in 2015. As part of the 2013 transaction, the Company made a permanent transfer of a 12.6 percent interest in the Cladhan field to TAQA in exchange for a repayable carry by TAQA of development expenditures on an 11.8 percent interest in Cladhan (the "Second Carry"), which was transferred to TAQA for the duration of the carry. Transfer of the 12.6 percent interest was completed in August 2013 and the Second Carry became available.

Pursuant to these TAQA funding arrangements, the Company retains a minimum 2 percent interest in Cladhan throughout, for which the original budgeted development cost is funded out of a portion of the fixed First Carry. The rest of the First Carry, which amounted to \$53.6 million in total at December 31, 2013, was available to fund development costs on the 11.8 percent interest and was fully utilized in the third quarter of 2014, at which point the Second Carry started to fund the ongoing development costs for the 11.8 percent interest only. A 17 percent per annum uplift is applicable to the balance of the Second Carry.

Due to cost and time overruns on the project and the drop in worldwide commodity prices, under the RPS pricing assumptions used in the Company's 2015 reserves report effective December 31, 2015 dated April 14, 2016 ("NI 51-101F1"), pay-out of the entire amount of the Second Carry is not now likely to occur and the liability has been re-measured to reflect the amount most likely to be repaid from future revenues of the 11.8 percent. The Second Carry balance has been re-measured down to \$17,462,000, with \$7,601,000 recorded as a current liability on the balance sheet as it is expected to reduce the carry over the next twelve months and \$9,861,000 was recorded as a non-current liability expected to be the balance of the carry that will be repaid. The recoverable amounts were based on the value in use method and were determined at the level of the cash generating unit determined to be the Cladhan development oil and gas property. The recoverable amounts were based on discounted future cash flows over the next eight years, derived using proved plus probable reserves as at September 30, 2016. The cash flows (based on level III fair value hierarchy) used commodity prices in the NI 51-101F1, produced by RPS, effective December 31, 2015 price forecast taking into account actual production in the first nine months of 2016 and a pre-tax discount rate of 17 percent. If the Second Carry does not pay-out Sterling has no further liability to TAQA regarding the 11.8 percent interest. The resulting reduction in the amount of liability that was due to be paid under the carry arrangements has seen a credit of \$29,574,000 recorded in the income statement (year ending December 31, 2015 - \$22,655,000). The corresponding 11.8 percent asset (see note 7) has also been impaired down to the same level as the non-financial liability and recorded under impairment of oil and gas properties.

In the event of a large increase in commodity prices and pay-out does occur then provided the remaining net present value of the field is positive, the 11.8 percent interest will be returned to Sterling whose equity interest would then be 13.8 percent. Sterling retains the contingent upside payments linked to future reserves pursuant to the First Carry.

#### 12) COMMITMENTS AND CONTINGENCIES

Commitments as at September 30, 2016 for the years 2016 through 2020 and thereafter, comprise the following:

	2016	2017	2018	2019	2020	Thereafter	Total
	\$000s	\$000s	\$000s	\$000s	\$000s	\$000s	\$000s
Facilities, oil and gas drilling	1,589	18,158	17,639	-	-	-	37,386
Licence fees	168	1,101	1,094	1,032	1,055	-	4,450
Other operating	138	350	295	126	-	-	909
Office and other leases	226	535	496	488	488	-	2,233
	2,121	20,144	19,524	1,646	1,543	-	44,978

The above facilities, oil and natural gas drilling commitments in 2016 relate to additional work on Breagh Phase 1 development costs and amounts for long lead items for drilling in 2017. One exploration/appraisal well is shown at 100 percent in each of 2017 and 2018 as commitments though it is intended these would progress under a farm-in agreement with these costs shared.

Costs under facilities, oil and gas drilling, office and other leases and other operating categories have reduced following the Romanian Sale (see note 5) as these have all been transferred to Carlyle to the extent they relate to the Romanian business.

Included in the table above under the office and other leases subtotal is a commitment for office space that was assigned to a third party in December 2013. Under the terms of the sublease, Sterling continues to be liable to the landlord for any default under the lease caused by the assignee. It is expected that approximately \$2,074,000 of the office and other leases commitment will be covered by this sub-lease.

### 13) SHARE CAPITAL

Authorized share capital consists of an unlimited number of common shares without nominal or par value. The holders of common shares are entitled to one vote per share and are entitled to receive dividends as recommended by the Board of Directors. Share capital issued and outstanding is as follows:

As at	September 30, 2016			December 31, 2015
	Shares	Amount	Shares	Amount
	000s	\$000s	000s	\$000s
Balance, beginning of the period Issued for cash:	441,573	427,440	381,200	419,940
– equity issuances	14,277,526	174,078	60,373	7,500
Less share issue costs	-	(5,777)	-	-
Less effects of share consolidation	(14,571,913)	-	-	<u> </u>
Balance, end of the period	147,186	595,741	441,573	427,440

On May 30, 2016 the Company completed a Rights Offering and completed a Recapitalization (See note 10).

At a meeting of shareholders on July 5, 2016, a resolution to consolidate the Company's Common Shares on the basis of 1 post-consolidation Common Share for every 100 existing Common Shares (the "Consolidation") was considered (as was required under the Recapitalization Agreement) and approved. The Common Shares traded post Consolidation on July 7, 2016. No fractional Common Shares were issued as a result of the Consolidation, with any such fractions rounded down to the nearest whole number. The principal benefit of the Consolidation was to bring the share price of the Company, which had been trading in a range of approximately C\$0.005 to C\$0.03 in the first half of 2016, into a more appropriate trading range with a resultant share price at a level more similar to that of quoted peer group companies.

As the Company has an unlimited number of Common Shares authorized for issuance, the Consolidation has not had any effect on the number of Common Shares that remain available for future issuances. The Common Shares reserved for issuance pursuant to any issued and outstanding convertible securities of the Company have also been reduced proportionately and, in the case of

the Company's Long-Term Incentive Plan ("LTIP"), Phantom Share Option Plan ("POP") and Stock Option Plan, any strike price, exercise price or market reference price threshold will also be increased proportionately, as applicable.

In the twelve months ended December 31, 2015, concurrent with the Romanian Sale (see note 5), Sterling has terminated the investment agreement signed with Gemini in 2007 for a cash consideration of \$10 million and the issuance to Gemini of 60,372,876 Common Shares of Sterling which had a market value at the time of issuance of \$7.5 million based on the 10 day volume-weighted average price of the Common Shares on the TSX-V for the period ending March 24, 2015, being C\$0.157 per share at an average exchange rate of US\$1 = C\$1.2664). Sterling's issued share capital rose to 441,573,000 Common Shares, an increase of approximately 15.8 percent. The Common Shares were issued pursuant to applicable prospectus exemptions and had a hold period which expired on December 27, 2015 pursuant to applicable securities laws.

## 14) SEGMENTED INFORMATION

The Company has four geographical reporting segments. The Company is domiciled in Canada. The United Kingdom and other international locations are involved in exploration and development operations. Other international comprises operations in France and the Netherlands. The Romanian segment has now been sold (see note 5) and historical amounts are included for information purposes only. Revenues recorded below were from three external customers. Information reported to the Company's management for the assessment of segment performance is focussed on the tangible, intangible and financial assets attributable to each segment.

	Canada	United Kingdom	Romania (Discontinued)	Other International	Consolidated
Segmented Results	\$000s	\$000s	\$000s	\$000s	\$000s
Three months ended September 30, 2016					
Revenues	-	11,704	-	-	11,704
Impairment of oil and gas properties	-	(2,739)	-	-	(2,739)
Net loss	(1,143)	(4,853)	-	(28)	(6,024)
Nine months ended September 30, 2016					
Revenues	-	36,560	-	-	36,560
Impairment of oil and gas properties	-	(17,724)	-	-	(17,724)
Net loss	(2,626)	(30,076)	-	(178)	(32,880)
Three months ended September 30, 2015					
Revenues	-	19,335	_	-	19,335
Impairment of oil and gas properties	-	(9,776)	-	-	(9,776)
Net loss	(2,427)	(8,541)	565	(352)	(10,755)
Nine months ended September 30, 2015					
Revenues	-	61,842	-	-	61,842
Impairment of oil and gas properties	-	(10,158)	-	-	(10,158)
Net loss	(4,118)	(42,790)	(2,420)	(1,094)	(50,422)
	Canada	United Kingdom	Romania (Discontinued)	Other International	Consolidated
Segmented Assets	\$000s	\$000s	\$000s	\$000s	\$000s
Nine months ended September 30, 2016					
Exploration and evaluation assets	-	13,355	-	8,690	22,045
Exploration and evaluation expenditures	-	250	-	158	408
Development properties	-	267,534	-	-	267,534
Development property expenditures	-	6,850	-	-	6,850
Nine months ended September 30, 2015					
Exploration and evaluation assets	-	14,965	-	9,877	24,842
Exploration and evaluation expenditures	-	808	-	(721)	87
Development properties	-	385,444	-	-	385,444
Development property expenditures	-	36,608	-	-	36,608

### 15) INCENTIVE PLANS

### A) STOCK OPTION PLAN

The Company has a stock option plan (the "Stock Option Plan") whereby, it may grant equity-settled options to its directors, officers, employees and consultants. On September 30, 2016, there were 177,000 (December 31, 2015 – 24,432,000) common shares reserved for issuance under the plan. The exercise price of each option equals the market price of the Company's common shares on the grant date. An option's maximum term is five years, with a minimum vesting period of 12 months. Stock options currently issued vest over the initial three years. The stock options are denominated in Canadian dollars and all dollar amounts in tables in this note represent the Canadian dollar amount.

Following the Consolidation (see note 13) the Company's Long-Term Incentive Plan ("LTIP"), Phantom Share Option Plan ("POP") and Stock Option Plan, any strike price, exercise price or market reference price threshold was increased proportionately, by a factor of 100 as applicable and the number of options under the Stock Option Plan was also reduced by a factor of 100.

The following table sets out a continuity of outstanding stock options:

	Nine months ended Se	ptember 30, 2016	Year ended	December 31, 2015
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Continuity of Common Share Options	000s	C\$	000s	C\$
Balance, beginning of the period	24,432	0.34	16,208	0.82
Granted during the period	-	-	12,935	0.07
Cancelled/forfeited during the period	(2,442)	0.39	(3,089)	0.83
Expired during the period	(590)	2.07	(1,622)	2.04
Outstanding, prior to consolidation	21,400	0.29	24,432	0.34
Balance, post consolidation	214	29.06	-	-
Cancelled/forfeited during the period	(36)	27.84	-	-
Expired during the period	(1)	138.00	-	
Outstanding, end of the period	177	28.69	-	
Exercisable, end of the period	86	36.87	4,403	0.81

A Black-Scholes option pricing model was used to calculate the fair value of the options granted during the year ended December 31, 2015 (there was no award during the nine month period ended September 30, 2016), using the following weighted-average assumptions:

	Year ended December 31, 2015
Weighted average share price	C\$0.07
Weighted average exercise price	C\$0.07
Risk-free interest rate	0.47%
Weighted average forfeiture rate	8.33%
Expected hold period to exercise	3.5 years
Volatility in the price of the Company's shares	80%
Expected annual dividend yield	0%

Volatility in the price of the Company's common shares is calculated using the daily average price quoted on the TSX Venture Exchange over the period immediately preceding the issue of the option which is equivalent to the expected hold period to exercise.

The calculation of the fair value of options granted assumes an option forfeiture rate based on the cumulative historical level of forfeitures at the time the option is issued.

The weighted average fair value of options granted during the year ended December 31, 2015 was Canadian \$0.04 per share.

For the nine month period ended September 30, 2016 \$266,000 (September 30, 2015 - \$685,000) of share-based compensation was expensed and was included in the employee expense figure of \$2,520,000 (2015 - \$3,225,000).

The following stock options were outstanding as at September 30, 2016:

			Options Outstanding		Optio	ns Exercisable	
				Weighted			Weighted
			Average	Average		Average	Average
			Remaining	Exercise		Remaining	Exercise
Exercise Pr	ice	Options	Contract	Price	Options	Contract	Price
From C\$	To C\$	000s	Life (Days)	C\$	000s	Life (Days)	C\$
7.00	49.99	97	1,423	7.00	32	1,423	7.00
50.00	99.99	80	970	55.00	54	970	55.00
7.00	99.99	177	1,219	28.69	86	1,141	36.87

## **B) LONG TERM INCENTIVE PLANS**

## **Phantom Option Plan**

Under the phantom option plan, a total of 270,000 phantom options were granted to employees who did not receive awards under the PSU Plan in May 2013 with an effective date of May 31, 2012 and an exercise price based on the Company's common share price at that date (C\$0.98/share). These phantom options have vested in three equal tranches on the first, second and third anniversaries of the award and will expire two years after vesting. At September 30, 2016, 164,000 of these phantom options had been forfeited and a further 83,000 have expired.

In October 2013, 255,840 phantom options were granted with an effective date of May 31, 2013 and an exercise price based on the Company's common share price on that date (C\$0.76/share). At September 30, 2016, 162,000 of these phantom options had been forfeited and a further 43,000 have expired.

The intrinsic value of outstanding phantom options at September 30, 2016 was nil (September 30, 2015 – nil).

## 16) NET REVENUE

	Three months ended Sep	Three months ended September 30,		September 30,
	2016	2015	2016	2015
	\$000s	\$000s	\$000s	\$000s
Breagh gas and condensate revenue	8,204	19,065	26,660	60,562
Other revenues including from hedging	-	270	40	1,280
Cladhan oil revenues	3,500	-	9,860	
	11,704	19,335	36,560	61,842
Third party entitlement	(509)	(1,483)	(1,559)	(6,394)
Total net revenue	11,195	17,852	35,001	55,448

### **BREAGH**

For the nine month period ended September 30, 2016, Breagh revenue was \$26,660,000 (nine month period ended September 30, 2015 - \$60,562,000). These revenues came from sales of gas production of approximately 6.2 billion cubic feet ("Bcf") at an average realized gas price of 30.8 pence per therm (\$4.31 per thousand cubic feet) and 2,354 tonnes of condensate (17,307 barrels) at an average price of \$305 per tonne. For the nine month period ended September 30, 2015, revenues came from sales of gas production of approximately 8.8 Bcf at an average realized gas price of 43.8 pence per therm (\$6.83 per thousand cubic feet), 3,600 tonnes of condensate (29,071 barrels) at an average price of \$425 per tonne. Up until September 30, 2016 the Company sold its gas under a Gas Trading and Services Agreement ("GTSA") with Vitol SA ("Vitol") signed in 2011 whereby Sterling nominates volumes on a day ahead or month ahead basis and achieves a price very close to the UK reference spot price at the National Balancing Point ("NBP"). If Sterling nominated gas to Vitol, it must deliver such a volume and Vitol must take and pay for this volume. The GTSA provided for payment to Sterling for over-deliveries, and a charge for under-deliveries, on normal market terms. Sterling was paid by Vitol in the month following production and one hundred percent of these revenues were derived from one customer and one contract.

On September 8, 2016, the Company announced that it had entered into a gas sales agreement with British Gas Trading Limited ("BGT"), a subsidiary of Centrica plc. The agreement provides for Sterling's share of Breagh nominated gas volumes to be sold on a day ahead basis to the UK reference price at the NBP. Under the contract Sterling nominates gas to BGT on a day ahead basis, and BGT must take and pay for this volume. The gas sales agreement incorporates arrangements for payment to Sterling for over-deliveries, and recovery of incremental costs incurred by BGT for under-deliveries, on normal market terms. The agreement is valid for a minimum two year period with gas made available to BGT commencing October 1, 2016. The agreement replaces the gas trading and services agreement with Vitol which expired on October 1, 2016. Sterling is paid by BGT in the month following production and one hundred percent of these revenues are derived from one customer and one contract.

The Breagh field produces a small amount of condensate (the condensate-gas ratio is approximately 3.1 barrels per million standard cubic feet) ("MMscf") which is sold to Petrochem Carless Ltd at a price linked to North West European spot prices for naphtha and other products, with cargoes typically being sold every one to three months. One hundred percent of these revenues are derived from one customer and one contract.

### THIRD PARTY ENTITLEMENT

For the three and nine month periods ended September 30, 2016, a third party entitlement of \$509,000 (three month period ended September 30, 2015 - \$1,483,000) and \$1,559,000 (nine month period ended September 30, 2015 - \$6,394,000), was charged to the income statement respectively. The current year amounts were lower due to a reduction to the rate of the entitlement payments from 12.23 percent to 6.10 percent late in 2015 and is commensurate with lower production revenues. This amount was recorded pursuant to a funding agreement originally signed with Gemini Oil & Gas Fund II, L.P ("Gemini") in 2007, which provided payments linked to any future production revenues from the Breagh field (which at the time had not been determined to be commercial). Cumulative costs from the fourth quarter of 2013 (during which period first production occurred) to September 30, 2016 amount to \$17,779,000.

# **CLADHAN**

First sales from the Cladhan oil development occurred in the first quarter of 2016. During the nine month period ended September 30, 2016, sales relating to the Company's 2 percent equity interest totalled \$1,600,000 which came from the sale of 38,300 barrels of oil equivalent ("boe") at an average realized price of \$42 per boe.

During the nine month period ended September 30, 2016, the Company also recognized \$8,260,000 of Cladhan revenues relating to sales of oil on the 11.8 per cent of the Cladhan development which is being funded by TAQA Bratani ("TAQA") (see "Financing Activities - Cladhan funding arrangements") for which no cash was received as the amount was withheld by TAQA to reduce the amounts it had previously paid on the Company's behalf under the carry arrangement.

While production on the Cladhan development commenced in mid-December 2015, no oil was sold and no revenues were recorded in the year ended December 31, 2015.

## 17) FINANCING COSTS

	Three months ended Sep	Three months ended September 30,		September 30,
	2016	<b>2016</b> 2015		2015
	\$000s	\$000s	\$000s	\$000s
Interest expense	901	9,948	12,200	25,344
Non-cash Cladhan funding arrangements	2,824	-	8,218	-
Amortization of bond transaction costs	426	-	426	-
Capitalization of borrowing costs	-	(2,483)	-	(5,828)
	4,151	7,465	20,844	19,516
Accretion of decommissioning discount (note 9)	116	323	360	871
Total financing costs	4,267	7,788	21,204	20,387

Financing costs for the nine month period ended September 30, 2016 were \$21,204,000 (nine month period ended September 30, 2015 - \$20,387,000) consisting primarily of borrowing costs of \$12,200,000 on the Bond and amortization of Bond transaction costs of \$426,000. In the nine months ended September 30, 2015 interest expense of \$5,828,000 relating to the Cladhan funding arrangements was capitalized as borrowing costs until the asset entered into production in mid-December whereupon capitalization ceased and the interest expense began to be expensed. In the nine months ended September 30, 2016, \$8,218,000 of Cladhan funding arrangement interest was expensed.

The balance of the financing costs include accretion of the discount on decommissioning obligations and have decreased in the period due to lower cost estimates on the decommissioning obligations on the Breagh development.

## 18) NET LOSS PER SHARE

The following reflects the loss and share data used in the computation of basic and diluted earnings per share:

	Three Months Ended Sep	Three Months Ended September 30,		September 30,
	2016	2015	2016	2015
Weighted average shares outstanding (000s)	147,186	404,168	309,421	388,940
Net income (loss) (\$000s)	(6,024)	(10,755)	(32,880)	(50,422)
Weighted average net income (loss) per share (\$)				
Basic	(0.04)	(0.03)	(0.11)	(0.13)
Diluted	(0.04)	(0.03)	(0.11)	(0.13)

In the calculation of the weighted average shares outstanding for the periods the effects of the Recapitalization (see note 10) and the Consolidation (see note 13) have been treated as occurring on the same day.

For the periods ended September 30, 2016 and 2015, the potential dilutive effect of the Company's outstanding options was not included in diluted shares as they were antidilutive.

### 19) DEFERRED TAX AND CURRENT TAX

#### **DEFERRED TAX**

The Company had a recognized deferred tax asset in the amount of \$194,013,000 as at December 31, 2014 principally relating to Sterling's UK tax losses. With sustained production history, management considered that, based on its profit forecast and reserves available, there was sufficient evidence to recognize this deferred tax asset.

As at December 31, 2015, the deferred tax asset decreased to \$66,073,000, mainly due to deferred tax benefits deemed not probable to be recovered in the current low commodity price environment of approximately \$92 million and lower estimated future SCT net relief of approximately \$34 million as a result of the 12 percent reduction in the statutory SCT rate. With effect from January 1, 2016 supplementary charge corporation tax ("SCT"), was further reduced from 20 to 10 percent on its activities within the UK oil and gas ring fence. The reduction from 20 to 10 percent was substantively enacted during the third quarter.

Sterling presently forecasts that in the current low commodity price environment existing carried-forward UK tax losses as at September 30, 2016 will not sufficiently be utilized in the UK subsidiary company Sterling Resources (UK) Ltd. in future years, both against the reversal of existing taxable temporary differences and in addition against future taxable profits from expected production from the Breagh and Cladhan fields. Under UK tax law, there is no statutory fixed time-limit determining an expiry of carried-forward UK tax losses. Accordingly, a UK deferred tax asset of \$57,867,000 as at September 30, 2016 (December 31, 2015 – \$66,073,000) has been recognized in the Balance Sheet, the difference relating to the SCT rate reduction and changes in foreign exchange rates partly offset by a reduction in the carrying value of assets in excess of their tax values.

With respect to the economic modelling, the following key inputs and sources have been used as evidence both quantitatively and qualitatively in the preparation of the projected forecast position:

- Information on reserves and cashflows for Breagh and Cladhan are drawn from the reports produced by Sterling's independent reserves evaluator RPS Energy:
  - i) RPS Energy Report "Reserves Evaluation for the Breagh Gas Field Quad 42 UK North Sea as at December 31, 2015 Executive Summary Report" and
  - ii) RPS Energy Report "Reserves and Resources Evaluation for the Cladhan Oil Field Quad 210 Licence Blocks UK North Sea as at December 31, 2015 Executive Summary Report".
- The following principal economic assumptions have been used by RPS Energy:
  - i) Gas prices: \$7.89/Mcf for 2016, \$8.83/Mcf for 2017, \$9.16/Mcf for 2018, \$9.34 for 2019 escalated 2 percent thereafter.
  - ii) Oil prices: \$44.00/bbl for 2016, \$50.00/bbl for 2017, \$58.00/bbl for 2018, \$65.00 for 2019, escalated 2 percent thereafter. Cladhan crude is assumed to realize a premium to Brent of \$1.13/bbl for 2016, \$0.88/bbl in 2017, \$0.88/bbl in 2018, \$0.92/bbl in 2019, \$0.97/bbl in 2020, \$1.02/bbl in 2021 and \$1.07 /bbl in 2022.
  - iii) Exchange rate throughout field life GBP/USD 1.50.
- RPS Energy has evaluated the economic life of field up to 2038 for Breagh and up to 2021 for Cladhan for the 2P (Proved plus Probable) reserves case.
- As at September 30, 2016 the Company had non-expiring non-capital losses of approximately \$641 million (December 31, 2015 \$728 million) and non-expiring supplementary charge losses of approximately \$534 million (December 31, 2015 \$621 million) which may be applied against future oil and gas ring-fence income for UK tax purposes.
- Management's best estimates on short-term oil and gas prices, costs arising from debt-financing, general and administrative expenses and near term exploration and appraisal expenses have been incorporated.

	\$000s	\$000s
Net book value of assets (in excess) of tax pools	(91,132)	(151,027)
Loss carry-forwards	245,770	342,587
Investment allowances	390	890
Decommissioning obligations	14,812	18,420
Less deferred tax benefits deemed not probable to be recovered	(111,973)	(144,797)
Deferred tax asset recognized at end of period	57,867	66,073

No deferred tax assets have been recognised on the following tax losses held by the Company at September 30, 2016 and other deductible temporary differences:

- Non-capital losses of approximately \$33 million (December 31, 2015 \$29 million) which may be applied against future income for Canadian tax purposes. These non-capital losses expire after twenty years, primarily between 2031 and 2035.
- Non-expiring tax pools of approximately \$3 million (December 31, 2015 \$3 million) which may be applied against future income for Canadian tax purposes.
- Non-capital losses and other tax deductible costs of approximately \$22 million (December 31, 2015 \$20 million) which may be applied against future income for Netherlands tax purposes. These expire after nine years from 2019 onwards.

## **CORPORATE INFORMATION**

### **DIRECTORS**

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London, England

GAVIN WILSON (1) (3) Zurich, Switzerland

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- (2) Chair of Reserves Committee
- (3) Audit Committee
- (4) Chair of Audit Committee
- (5) Governance and Compensation Committee
- (6) Chair of Governance and Compensation Committee

#### **OFFICERS**

JOHN M. RAPACH

Chief Executive and Operating Officer

**CHRISTINE SHINNIE** 

**Chief Financial Officer** 

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Corporate Secretary

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**RPS ENERGY** 

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