HEADWATER EXPLORATION INC.
Interim Condensed Statements of Financial Position
(unaudited)

(Cdn$ thousands)	September 30 2021	December 31 2020
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	84,132	76,772
Restricted cash (notes 13 & 15)	1,598	1,827
Accounts receivable (note 13)	22,241	5,475
Financial derivatives receivable (note 13)	-	74
Inventories	580	571
Prepaids and deposits	784	448
Total current assets	109,335	85,167
Exploration and evaluation assets (note 3)	28,801	27,101
Property, plant and equipment (note 4)	271,197	187,664
Right-of-use assets (note 5)	1,157	418
Other assets	335	335
Total assets	410,825	300,685
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 13)	44,834	4,105
Financial derivatives liability (note 13)	8,984	-
Deferred share units liability (note 9)	173	91
Current portion of lease liability (note 5)	619	138
Warrant liability (note 7)	38,235	10,305
Total current liabilities	92,845	14,639
Lease liability (note 5)	573	298
Decommissioning liability (note 6)	21,879	16,718
Total liabilities	115,297	31,655
Shareholders' Equity		
Capital stock (note 8)	396,099	387,393
Warrants (note 8)	5,449	7,659
Contributed surplus	13,760	11,659
Deficit	(119,780)	(137,681)
Total shareholders' equity	295,528	269,030
Total liabilities and shareholders' equity	410,825	300,685

Commitments (note 15)
Subsequent events (note 16)

See accompanying notes to the interim condensed financial statements

Approved on behalf of the Board of Directors:

(signed) "Chandra Henry"
Chandra Henry, CPA, CA
Director

(signed) "Neil Roszell"
Neil Roszell
Chairman

HEADWATER EXPLORATION INC.
Interim Condensed Statements of Income (Loss) and Comprehensive Income (Loss)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2021	2020	2021	2020
(Cdn$ thousands, except per share data)	$	$	$	$
REVENUE				
Sales (note 10)	50,123	-	115,653	2,873
Royalties	(7,323)	-	(15,029)	(72)
Revenue, net of royalties	42,800	-	100,624	2,801
Gains (losses) on financial derivatives (note 13)	(7,346)	(280)	(9,463)	2,325
	35,454	(280)	91,161	5,126
EXPENSES				
Blending and transportation	7,360	-	19,898	-
Production	3,099	519	8,472	1,700
General and administrative	983	607	2,801	2,132
Transaction costs	-	-	-	4,382
Remeasurement loss on warrant liability (note 7)	2,762	-	27,930	-
Stock-based compensation expense (note 9)	608	492	1,738	902
Depletion and depreciation (notes 4 & 5)	10,889	75	28,598	3,334
Impairment reversal (note 4)	(16,293)	-	(16,293)	-
Exploration and evaluation expense (note 3)	-	-	-	3,821
	9,408	1,693	73,144	16,271
Interest income and other expense (note 11)	60	250	(116)	933
Net income (loss) and comprehensive income (loss)	**26,106**	**(1,723)**	**17,901**	**(10,212)**
Net income (loss) per share (note 8)				
Basic	0.13	(0.01)	0.09	(0.08)
Diluted	0.12	(0.01)	0.08	(0.08)

See accompanying notes to the interim condensed financial statements

HEADWATER EXPLORATION INC.
Interim Condensed Statements of Cash Flows
(unaudited)

Cash flow related to the following activities:	Three months ended September 30, 2021	Three months ended September 30, 2020	Nine months ended September 30, 2021	Nine months ended September 30, 2020
(Cdn$ thousands)	$	$	$	$
OPERATING				
Net income (loss)	26,106	(1,723)	17,901	(10,212)
Items not involving cash:				
Unrealized losses on financial derivatives (note 13)	7,346	280	9,058	1,612
Remeasurement loss on warrant liability	2,762	-	27,930	-
Stock-based compensation expense	608	492	1,738	902
Depletion and depreciation	10,889	75	28,598	3,334
Impairment reversal	(16,293)	-	(16,293)	-
Exploration and evaluation expense	-	-	-	3,821
Accretion and finance charges (note 11)	106	39	253	127
Change in non-cash operating working capital (note 12)	(3,636)	473	(5,282)	2,097
Cash flows provided by (used in) operating activities	27,888	(364)	63,903	1,681
FINANCING				
Issue of common shares, net of costs (note 8)	-	-	-	48,096
Payment of lease liability (note 5)	(104)	(38)	(176)	(111)
Proceeds from exercise of stock options & Warrants (note 8)	166	-	5,713	2,079
Cash flows provided by (used in) financing activities	62	(38)	5,537	50,064
INVESTING				
Capital expenditures – property, plant and equipment (note 4)	(31,840)	(6)	(85,139)	(130)
Capital expenditures – exploration and evaluation (note 3)	(5,453)	(55)	(6,207)	(399)
Change in restricted cash	(1,248)	380	229	680
Change in non-cash investing working capital (note 12)	14,800	(36)	29,037	(181)
Cash flows provided by (used in) investing activities	(23,741)	283	(62,080)	(30)
Change in cash and cash equivalents	4,209	(119)	7,360	51,715
Cash and cash equivalents, beginning of period	79,923	112,791	76,772	60,957
Cash and cash equivalents, end of period	84,132	112,672	84,132	112,672

See accompanying notes to the interim condensed financial statements

HEADWATER EXPLORATION INC.
Interim Condensed Statements of Changes in Shareholders' Equity
(unaudited)

(Cdn$ thousands)	Notes	Capital stock $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' equity $
Balance at January 1, 2020		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Issued on Recapitalization Transaction	8	50,000	-	-	-	50,000
Allocation to Warrants	8	(7,680)	7,680	-	-	-
Issue costs	8	(1,905)	-	-	-	(1,905)
Exercise of stock options	8	3,199	-	(1,120)	-	2,079
Stock-based compensation	9	-	-	876	-	876
Net loss		-	-	-	(10,212)	(10,212)
Balance at September 30, 2020		**290,946**	**7,680**	**11,122**	**(154,600)**	**155,148**
Balance at January 1, 2021		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**
Exercise of stock options	8	801	-	(783)	-	18
Exercise of Warrants	8	7,905	(2,210)	-	-	5,695
Stock-based compensation	9	-	-	2,884	-	2,884
Net income		-	-	-	17,901	17,901
Balance at September 30, 2021		**396,099**	**5,449**	**13,760**	**(119,780)**	**295,528**

See accompanying notes to the interim condensed financial statements

HEADWATER EXPLORATION INC.
Notes to the Interim Condensed Financial Statements
(unaudited)

As at and for the three and nine months ended September 30, 2021 and 2020

(All tabular amounts in thousands, unless otherwise stated)

1. NATURE OF OPERATIONS

Headwater Exploration Inc. ("Headwater" or the "Company") is a Canadian junior resource company engaged in the exploration for and development and production of petroleum and natural gas in Canada. Headwater is a public company existing under the Alberta Business Corporations Act with common shares listed on the Toronto Stock Exchange ("TSX") under the symbol "HWX".

Headwater's principal place of business is located at 1200, 500 – 4TH Avenue S.W., Calgary, Alberta, T2P 2V6 and its registered office is located at 2400, 525 - 8th Avenue S.W., Calgary Alberta, T2P 1G1.

2. BASIS OF PREPARATION

Statement of compliance

These unaudited interim condensed financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), and in accordance with IAS 34 – *Interim Financial Reporting*. The unaudited interim condensed financial statements do not include all information required for annual financial statements and should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2020. These unaudited interim condensed financial statements have been prepared following the same accounting policies as the Company's audited financial statements for the year ended December 31, 2020.

These unaudited interim condensed financial statements were approved and authorized for issue by the Company's Board of Directors on November 10, 2021.

Basis of measurement, functional and presentation currency

The financial statements have been prepared on a historical cost basis except for certain financial instruments which are measured at fair value through profit or loss and inventories which are measured at the lower of cost and net realizable value.

The financial statements are presented in Canadian dollars, which is the Company's functional currency.

Significant judgments, estimates and accounting policies

The timely preparation of the financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amount of assets, liabilities, income and expenses. Actual results may differ materially from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Significant judgments, estimates and assumptions made by management in these financial statements are outlined in note 2 of the December 31, 2020 annual financial statements. There have been no significant changes in the Company's judgments and estimates applied during the interim period ended September 30, 2021, relative to those described in the most recent annual financial statements as at and for the year ended December 31, 2020.

Since December 31, 2019, the outbreak of the COVID-19 pandemic has had a significantly negative impact on economic conditions around the world. This has resulted in significant volatility of commodity prices as well as increased economic uncertainty. Estimates and judgments made by management in the preparation of the interim condensed financial statements are increasingly difficult and subject to a higher degree of measurement uncertainty during this volatile period.

3. EXPLORATION AND EVALUATION ("E&E") ASSETS

Exploration and evaluation assets consist of the Company's undeveloped land, geological and geophysical assets and exploratory drilling costs for projects in which technical feasibility or commercial viability has yet to be determined.

The following table reconciles the movements of the Company's E&E assets for the periods:

	September 30, 2021	December 31, 2020
	$	$
Balance, beginning of period	27,101	3,816
Acquired - property acquisition	-	26,637
Additions	6,207	469
Transfers to PP&E	(4,507)	-
Expensed	-	(3,821)
Balance, end of period	28,801	27,101

The Company concluded there are no indicators of impairment for its E&E assets at September 30, 2021.

4. PROPERTY, PLANT AND EQUIPMENT ("PP&E")

The following table reconciles the movements of the Company's PP&E assets for the periods:

	Oil and gas properties	Office and other assets	Total
Cost	$	$	$
Balance at December 31, 2019	324,448	2,684	327,132
Acquired - property acquisition	119,636	-	119,636
Additions	1,753	55	1,808
Changes in decommissioning liabilities	2,884	-	2,884
Balance at December 31, 2020	448,721	2,739	451,460
Additions	86,356	11	86,367
Transfers from E&E	4,507	-	4,507
Changes in decommissioning liabilities	4,930	-	4,930
Balance at September 30, 2021	544,514	2,750	547,264
Accumulated depletion, depreciation and impairment			
Balance at December 31, 2019	270,946	2,068	273,014
Depletion or depreciation expense	5,733	83	5,816
Impairment reversal	(15,054)	-	(15,054)
Write-down of assets	20	-	20
Balance at December 31, 2020	261,645	2,151	263,796
Depletion or depreciation expense	28,506	58	28,564
Impairment reversal	(16,293)	-	(16,293)
Balance at September 30, 2021	273,858	2,209	276,067

Net book value at December 31, 2020	187,076	588	187,664
Net book value at September 30, 2021	270,656	541	271,197

As at September 30, 2021, the calculation of depletion includes estimated future development costs relating to the development of proved plus probable reserves of $41.3 million (December 31, 2020 – proved plus probable reserves of $48.0 million).

The Company capitalized $605 thousand of general and administrative costs for the nine months ended September 30, 2021 (year ended December 31, 2020 – $80 thousand) and capitalized stock-based compensation expense of $1,228 thousand for the nine months ended September 30, 2021 (year ended December 31, 2020 – $nil).

Q3 2021 Impairment Assessment – Alberta CGU

The Company concluded there are no indicators of impairment for its Alberta CGU as at September 30, 2021.

Q3 2021 Impairment Reversal – New Brunswick CGU

In the third quarter of 2021, due to a significant increase in forecast natural gas pricing, the Company determined an indicator of impairment reversal was present for its New Brunswick CGU. As a result, the Company completed an impairment reversal test and recognized a reversal of previous impairment losses of $16,293 thousand; this amount represents the full amount available to be reversed.

The recoverable amount was estimated based on the fair value less costs of disposal ("FVLCD") methodology which is calculated using the present value of the CGU's estimated cash flows associated with proved and probable natural gas reserves. The cash flow information was derived from an internal reserve report on the Company's McCully assets which was prepared by management as of September 30, 2021.The projected cash flows used in the FVLCD calculation reflect market assessments of key assumptions as at September 30, 2021, including long-term forecasts for natural gas commodity prices, inflation rates and foreign exchange rates (Level 3 fair value inputs). Cash flow forecasts are also based on the Company's reserves and individual well production profiles, operating and royalty costs and future development costs. Royalty rates used in the FVLCD calculation are consistent with the New Brunswick government's royalty regime in effect as of September 30, 2021.

The discount rate used in the impairment reversal calculation was 12% and was determined based on a peer group weighed average cost of capital factoring in risks specific to the types of reserves. The carrying value of the New Brunswick CGU at September 30, 2021 was $48.9 million prior to any impairment reversal.

Forecast natural gas commodity pricing used in the FVLCD calculation as at September 30, 2021 reflects the benchmark prices set forth in the table below. McCully natural gas prices were calculated by adjusting the Algonquin city-gates natural gas prices to reflect the expected premiums received at Headwater's delivery point, net of transportation costs, if applicable, and heat content.

	2021	2022	2023	2024	2025	2026 – 2030	Thereafter
Algonquin city-gates ($US/mmbtu)	10.50	7.25	5.44	4.37	4.46	4.55 – 4.92	+2%/year
McCully ($CDN/mcf) (1)	17.56	12.43	8.93	6.25	6.86	7.00 – 7.57	+2%/year
Exchange rate ($US/$CDN)	0.80	0.80	0.80	0.80	0.80	0.80	0.80

(1) Realized pricing reflects natural gas production through the winter producing months (January to April and November to December of the applicable year) in 2021 to 2023.

Changes in key assumptions, such as a downward revision in natural gas reserves, a decrease in forecast natural gas commodity prices, changes in foreign exchange rates, an increase in royalties, operating costs or future development costs would decrease the recoverable amount of the CGU and the amount of the impairment reversal with a corresponding decrease to the Company's net income for the period.

As at September 30, 2021, a 1% increase in the discount rate and/or a 5% decrease in forecast operating cash flows would result in the following reduction to the Company's impairment reversal for the period:

	Decrease to impairment reversal
	$
1% increase in discount rate	-
5% decrease in cash flows	(268)
1% increase in discount rate and 5% decrease in cash flows	(2,210)

5. LEASES

Right-of-use assets

The following table reconciles the right-of-use assets by class as at September 30, 2021:

	Office and equipment leases	Surface rentals	Vehicles	Total
Cost	$	$	$	$
Balance at December 31, 2019	170	174	89	433
Additions	289	-	-	289
Dispositions	-	-	(89)	(89)
Balance at December 31, 2020	459	174	-	633
Additions	910	-	-	910
Balance at September 30, 2021	1,369	174	-	1,543
Accumulated depreciation				
Balance at December 31, 2019	113	8	23	144
Depreciation expense	86	8	22	116
Dispositions	-	-	(45)	(45)
Balance at December 31, 2020	199	16	-	215
Depreciation expense	163	8	-	171
Balance at September 30, 2021	362	24	-	386
Net book value as at December 31, 2020	260	158	-	418
Net book value as at September 30, 2021	1,007	150	-	1,157

Lease liability

The following table reconciles the changes in the lease liability for the periods:

	September 30, 2021	December 31, 2020
	$	$
Lease liability, beginning of period	436	285
Additions	910	288
Dispositions	-	(38)
Interest expense	22	11
Payment of lease liability	(176)	(110)
Lease liability, end of period	1,192	436
Current portion of lease liability	619	138
Non-current portion of lease liability	573	298
Total lease liability	1,192	436

During the nine months ended September 30, 2021, the weighted average discount rate used was 5.2%.

6. DECOMMISSIONING LIABILITY

The following table reconciles the movements of the Company's decommissioning liability for the periods:

	September 30, 2021	December 31, 2020
	$	$
Balance, beginning of period	16,718	11,976
Acquired - property acquisition	-	1,709
Additions	7,241	50
Change in estimate (1)	(2,311)	606
Accretion	231	149
Revaluation of liabilities acquired	-	2,228
Balance, end of period	21,879	16,718

(1) Relates to an increase in the risk-free rate partially offset by an increase in the inflation rate. The change in risk-free rate from 1.2% at December 31, 2020 to 2.0% at September 30, 2021 results in a decrease to the decommissioning liability of $3.2 million and the change in inflation rate from 1.5% at December 31, 2020 to 1.7% at September 30, 2021 results in an increase to the decommissioning liability of $0.9 million.

The Company's decommissioning liabilities are based on the Company's net ownership in wells and related infrastructure.

The Company has estimated the net present value of its total decommissioning liabilities to be $21.9 million as at September 30, 2021 (December 31, 2020 - $16.7 million). The total future undiscounted amount of estimated cash flows required to settle these obligations is $35.3 million (December 31, 2020 - $23.6 million). Management estimates the settlement of these obligations will occur over the next 17 to 32 years. At September 30, 2021, a risk-free rate of 2.0% (December 31, 2020 – 1.2%) and an inflation rate of 1.7% (December 31, 2020 – 1.5%) were used to calculate the estimated fair value of the decommissioning liability.

7. WARRANT LIABILITY

The following table reconciles the movements of the Company's warrant liability for the periods:

	September 30, 2021	December 31, 2020
	$	$
Warrant liability, beginning of period	10,305	-
Issued - acquisition	-	6,016
Remeasurement loss on warrant liability	27,930	4,289
Warrant liability, end of period	38,235	10,305

As at September 30, 2021, there were 15 million warrants outstanding which have an exercise price of $2.00 and expire in December 2023. Headwater has the right, after twelve months have elapsed from December 2, 2020 and provided the 20-day volume weighted average share price of the Company's common shares exceeds the exercise price of the warrants, to require the holder to exercise all or a portion of the then outstanding warrants. The warrants issued were classified as a financial liability as a result of a cashless exercise provision. These warrants are exercisable and have therefore been presented as a current liability in the Statement of Financial Position. In no event will the Company be required to settle the warrants through a cash payment.

The fair value of the warrants on September 30, 2021 and on December 31, 2020 was determined using a Monte Carlo simulation pricing model with the following inputs:

	September 30, 2021	December 31, 2020
Share price	$4.55	$2.39
Risk-free interest rate	0.6%	0.3%
Expected life (years) (1)	0.2	0.9
Expected volatility (2)	58%	56%

(1) While the total term of the warrants is three years, the Company has used one year to value the warrants as this represents the period until Headwater can exercise its call right.
(2) Expected volatility is based on a historical peer group volatility.

8. CAPITAL STOCK

a) Authorized – unlimited common shares without nominal or par value.

b) Issued and outstanding

	September 30, 2021		December 31, 2020	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of period	195,106	387,393	88,147	247,332
Recapitalization Transaction:				
Common shares issued for cash proceeds	-	-	54,347	50,000
Allocation to warrants	-	-	-	(7,680)
Common shares issued on acquisition	-	-	50,000	96,500
Share issue costs	-	-	-	(2,036)
Exercise of stock options	1,116	801	2,550	3,198
Exercise of Warrants	6,244	7,905	62	79
Balance, end of period	202,466	396,099	195,106	387,393

Stock Options

During the nine months ended September 30, 2021, 1,441 thousand stock options were exercised for 1,116 thousand common shares. Contributed surplus related to the stock options exercised of $783 thousand was transferred to capital stock.

Warrants

During the nine months ended September 30, 2021, 6,257 thousand Warrants were exercised for 6,244 thousand common shares. The associated fair value of the Warrants of $2,210 thousand was transferred to capital stock.

2020 Recapitalization Transaction

On March 4, 2020, the Company completed a recapitalization transaction (the "Recapitalization Transaction"). The Recapitalization Transaction involved the following:

- A non-brokered private placement of 21,739,130 units of the Company at a price of $0.92 per unit for aggregate gross proceeds of $20.0 million. Each unit was comprised of one common share and one common share purchase warrant ("Warrant") of the Company. Each Warrant entitles the holder to purchase one common share at a price of $0.92 per common share for a period of 4 years from the issuance date. Pursuant to the rules of the TSX, the non-brokered private placement was approved by shareholders of the Company at a special meeting held on March 4, 2020. As at September 30, 2021, the Warrants are fully vested and exercisable.

- Concurrently with the closing of the non-brokered private placement, the appointment of a new management team and reconstitution of the Board of Directors was completed.

- A brokered private placement of 32,608,696 subscription receipts ("Subscription Receipts") of the Company, which were issued at a price of $0.92 per Subscription Receipt through a syndicate of dealers for aggregate gross proceeds of $30.0 million, was completed on February 11, 2020. Pursuant to the terms of the Subscription Receipts, upon completion of the non-brokered private placement, reconstitution of the Board of Directors and appointment of the new management team on March 4, 2020, the net proceeds of the brokered private placement were released to the Company and each holder of Subscription Receipts received one common share for each Subscription Receipt held.

- Pursuant to the Recapitalization Transaction, the Company incurred $4,382 thousand of transaction costs and $1,905 thousand of share issue costs.

c) Warrants

	September 30, 2021		December 31, 2020	
	Number of warrants	Amount	Number of warrants	Amount
		$		$
Balance, beginning of period	21,677	7,659	-	-
Issued on Recapitalization Transaction	-	-	21,739	7,680
Exercise of Warrants	(6,257)	(2,210)	(62)	(21)
Balance, end of period	15,420	5,449	21,677	7,659

As at September 30, 2021, there were 15.4 million Warrants outstanding which have an exercise price of $0.92 and expire in March 2024. The fair value of the Warrants is recorded in shareholders' equity. Subsequently, any consideration paid to the Company on the exercise of Warrants along with the fair value of Warrants will be credited to capital stock.

The Warrants issued in connection with the non-brokered private placement during the year ended December 31, 2020 were allocated a fair value of $7,680 thousand. The fair value was estimated using the Black-Scholes model with the following assumptions: expected life of four years; volatility of 50%; risk-free interest rate of 0.9%; and a dividend yield of 0%. The expected volatility was estimated based on a peer group historical volatility over a four-year period.

d) Per share amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding. The Company uses the treasury stock method to determine the impact of dilutive securities. The reconciling items between basic and diluted average common shares outstanding are stock options and warrants.

	Three months ended September 30,		Nine months ended September 30,	
	2021	2020	2021	2020
Weighted average shares outstanding				
Basic	202,313	145,044	198,385	131,997
Diluted	218,190	145,044	214,166	131,997

In computing the diluted weighted average shares outstanding for the three months ended September 30, 2021, 7,458,702 warrants issued to Cenovus were excluded as they were anti-dilutive.

In computing the diluted weighted average shares outstanding for the nine months ended September 30, 2021, 7,355,237 warrants issued to Cenovus were excluded as they were anti-dilutive.

As the Company incurred a net loss for the three and nine months ended September 30, 2020, in computing the diluted net loss per share, the effect of stock options and Warrants were excluded as they were anti-dilutive.

9. STOCK-BASED COMPENSATION

a) Stock options

The Company has a stock option plan ("Old Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. The exercise price of each option granted under the Old Option Plan is based on the closing price of the common shares on the TSX on the trading day prior to the date the option was granted. Options granted under the Old Option Plan generally vest equally over a three-year period and expire four to five years after the grant date. The Company does not intend to grant any additional options under the Old Option Plan.

On March 25, 2020, the Company's Board of Directors approved a new share option plan ("New Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. Under the terms of the New Option Plan, an aggregate number of options equal to 8.0% of the aggregate number of issued and outstanding common shares less the aggregate number of common shares issuable pursuant to the outstanding options under the Old Option Plan may be granted. The exercise price of each option granted under the New Option Plan is based on the closing price of the common shares on the TSX on the trading day prior to the date the option was granted and generally options vest equally over a three-year period and expire four years from the date of grant.

The following table summarizes the changes in the outstanding stock options for the periods:

	Nine months ended September 30, 2021		Year ended December 31, 2020	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	7,978	$ 1.32	3,490	$ 0.79
Granted	3,180	$ 4.16	7,905	$ 1.34
Forfeited, cancelled or expired	(55)	$ 2.84	(867)	$ 0.79
Exercised [(1)]	(1,441)	$ 1.02	(2,550)	$ 0.82
Options outstanding, end of period	9,662	$ 2.29	7,978	$ 1.32
Options exercisable, end of period	750	$ 1.04	169	$ 0.70

(1) The Company's weighted average share price, at the date of exercise, for stock options exercised during the nine months ended September 30, 2021 was $4.49 per common share (nine months ended September 30, 2020 - $1.25 per common share).

The fair value of options granted is estimated using the Black-Scholes option pricing model with the following assumptions:

	September 30, 2021	December 31, 2020
Weighted average fair value of options granted	$ 1.52	$ 0.61
Risk-free interest rate	0.4%	0.3%
Expected forfeiture rate	9.6%	9.7%
Expected life (years)	2.5	3.6
Expected volatility [(1)]	60%	60%

(1) During the nine months ended September 30, 2021, the expected volatility was estimated based on a peer group historical volatility.

The range of exercise prices of stock options outstanding and exercisable as at September 30, 2021 is as follows:

	Outstanding options			Exercisable options	
Exercise prices	Number of options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$ 0.68 - $ 1.00	542	2.41	$ 0.93	54	$ 0.71
$ 1.01 - $ 2.00	4,330	2.49	$ 1.06	696	$ 1.06
$ 2.01 - $ 3.00	2,290	3.23	$ 2.50	-	-
$ 3.01 - $ 4.66	2,500	3.48	$ 4.53	-	-
Total	9,662	2.92	$ 2.29	750	$ 1.04

For the nine months ended September 30, 2021, the Company recorded gross stock-based compensation expense of $2.9 million and capitalized stock-based compensation expense of $1.2 million with a corresponding increase to contributed surplus of $2.9 million with respect to stock options (nine months ended September 30, 2020 - $876 thousand stock-based compensation with a corresponding increase to contributed surplus).

b) Deferred share units

The Company has a deferred share unit ("DSU") plan for directors. Each vested DSU will automatically be redeemed on the third business day after the date the director ceases to be a director of Headwater. When redeemed, each vested DSU will be paid based on the weighted average trading price of the common shares over the five previous trading days.

The following table summarizes the changes in the outstanding DSUs for the periods:

	September 30, 2021		December 31, 2020	
	Number of DSUs	Amount	Number of DSUs	Amount
		$		$
DSUs, beginning of period	38	91	447	322
DSUs redeemed during the period (1)	-	-	(409)	(535)
Fair value adjustment during the period	-	82	-	304
DSUs, end of period	38	173	38	91

(1) DSUs were paid out pursuant to the Recapitalization Transaction and the reconstitution of the Board of Directors.

The DSU liability as at September 30, 2021 of $173 thousand is based on a fair value of $4.55 per DSU which is the Company's closing share price on September 30, 2021 (December 31, 2020 - $2.39 per DSU).

10. SALES

The following table presents the Company's sales disaggregated by revenue source:

	Three months ended September 30,		Nine months ended September 30,	
	2021	2020	2021	2020
	$	$	$	$
Heavy oil	49,984	-	108,396	-
Natural gas sales	127	-	6,411	2,500
Gathering, processing and transportation	12	-	784	336
Natural gas liquids sales	-	-	62	37
	50,123	-	115,653	2,873

The Company's heavy oil, natural gas and NGL revenues for the nine months ended September 30, 2021 were primarily derived from variable priced contracts based on index prices.

Included in accounts receivable as at September 30, 2021 is $22.2 million (December 31, 2020 - $4.5 million) of accrued sales related to September 2021 production.

11. INTEREST INCOME AND OTHER EXPENSE

Interest income and other consist of the following:

	Three months ended September 30,		Nine months ended September 30,	
	2021	2020	2021	2020
	$	$	$	$
Interest income	154	288	504	908
Foreign exchange gains (losses)	12	(1)	(367)	153
Accretion	(92)	(29)	(231)	(117)
Interest on lease liability	(14)	(8)	(22)	(11)
	60	250	(116)	933

12. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended September 30,		Nine months ended September 30,	
	2021	2020	2021	2020
	$	$	$	$
Change in non-cash operating working capital:				
Accounts receivable	(6,597)	287	(16,766)	2,779
Inventories	(118)	-	129	-
Prepaids and deposits	(134)	193	(336)	(100)
Accounts payable and accrued liabilities	3,213	(7)	11,691	(582)
	(3,636)	473	(5,282)	2,097
Change in non-cash investing working capital:				
Accounts payable and accrued liabilities	14,800	(36)	29,037	(181)
	14,800	(36)	29,037	(181)

13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Financial instruments of the Company include cash and cash equivalents, restricted cash, accounts receivable, deposits, accounts payable and accrued liabilities, financial derivatives liability and the warrant liability. The Company is exposed to financial risks arising from its financial assets and liabilities that include credit risk and liquidity risk in addition to market risks associated with commodity prices and foreign exchange rates.

a) The Company is exposed to the following risks:

i) Commodity price risk

Headwater enters into financial derivative commodity contracts to manage the risks associated with fluctuations in commodity prices. All such transactions are conducted in accordance with the Company's established risk management policies. The Company does not use derivative financial instruments for speculative purposes.

The Company had the following outstanding financial derivative commodity contracts as at September 30, 2021:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT (1)	Fixed	Nov 2021	2,500 mmbtu	Cdn$5.71/mmbtu
Natural Gas	AGT (1)	Fixed	Dec 2021	2,500 mmbtu	US$15.01/mmbtu (6)
Natural Gas	AGT Basis (1) (2)	Differential	Dec 1- Mar 31, 2022	2,500 mmbtu	Cdn$4.16/mmbtu
Natural Gas	AGT Basis (1) (3)	Differential	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$7.26/mmbtu
Natural Gas	NYMEX (4)	Fixed	Dec 1- Mar 31, 2022	2,500 mmbtu	Cdn$3.76/mmbtu
Natural Gas	AGT (1)	Fixed	Mar 2022	2,500 mmbtu	US$8.93/mmbtu (6)
Natural Gas	NYMEX (4)	Fixed	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$3.85/mmbtu
Crude Oil	WCS Basis (5)	Differential	Oct 1- Dec 31, 2021	2,000 bbls	US$13.16/bbl

(1) AGT = Algonquin city-gates
(2) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn$4.16/mmbtu
(3) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn$7.26/mmbtu
(4) NYMEX = NYMEX Henry Hub
(5) WCS = Western Canadian Select. Headwater pays on WCS while counterparty pays on WTI (West Texas Intermediate) less USD$13.16/bbl
(6) Subsequent to September 30, 2021, AGT hedges converted to Cdn at a Cdn/US rate of 1.24

As security for certain financial derivative commodity contracts, the counterparty has the authority to hold Headwater funds in the amount of US$6.5 million.

In order to establish a risk management facility to be able to enter into various financial derivative commodity contracts with a separate financial institution, Headwater entered into a demand debenture in the principal amount of $75 million providing for a floating charge over all assets of the Company. The risk management facility does not have any financial covenants that must be adhered to and the Company is in compliance with all other covenants.

Financial derivatives

The following table summarizes the Company's financial derivative gains (losses) for the periods:

	Three months ended September 30, 2021	Three months ended September 30, 2020	Nine months ended September 30, 2021	Nine months ended September 30, 2020
	$	$	$	$
Gains (losses) on financial derivatives:				
- realized gains (losses)	-	-	(405)	3,937
- unrealized losses	(7,346)	(280)	(9,058)	(1,612)
Gains (losses) on financial derivatives	(7,346)	(280)	(9,463)	2,325

The following table summarizes the fair value as at September 30, 2021 and the change in fair value for the nine months ended September 30, 2021:

	Commodity contracts	Foreign exchange contracts	Total
	$	$	$
Net financial derivatives receivable, beginning of period	74	-	74
Unrealized change in fair value	(9,056)	(2)	(9,058)
Net financial derivatives liability, end of period	(8,982)	(2)	(8,984)

The fair value of the financial derivatives liability related to the Company's commodity contracts of $9.0 million as at September 30, 2021 is based on estimated future crude oil and natural gas prices as of that date. The fair values of these financial derivative commodity contracts are sensitive to changes in the crude oil and natural gas reference prices. Holding other assumptions constant, if WCS and AGT prices increased (decreased) by 10%, the fair value of the financial derivatives liability would increase (decrease) by $1.8 million.

ii) Foreign currency risk

The Company is exposed to fluctuations of the Canadian to U.S. dollar exchange rate given realized pricing is directly influenced by U.S. dollar denominated benchmark pricing and from exposure to its U.S. dollar denominated heavy oil and natural gas marketing arrangements.

Headwater mitigates this risk by entering into commodity contracts in Canadian dollars and entering into foreign exchange contracts.

The Company had the following outstanding foreign exchange contract as at September 30, 2021:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, September 2021 average [(1)]	US$16,300,000	October 25, 2021

(1) WM/Reuters Intraday Spot Rate as of Noon EST

The Company had the following financial instruments denominated in U.S. dollars:

(thousands of U.S. dollars)	September 30, 2021	December 31, 2020
	$	$
Cash	240	7
Accounts receivable	17,382	1,031
Financial instruments in U.S. dollars	17,622	1,038

At September 30, 2021, a 5% decrease in the CAD$/USD$ exchange rate would have resulted in a decrease of approximately $84 thousand to the Company's net income. Conversely, a 5% increase in the CAD$/USD$ exchange rate would have resulted in an increase of approximately $84 thousand to the Company's net income.

Fair Value Measurement

The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The Company maximizes the use of observable inputs when preparing calculations of fair value, where possible. The fair value hierarchy has the following levels:

- Level 1 – Values are used based on unadjusted quoted prices available in active markets for identical assets and liabilities as of the reporting date.
- Level 2 – Values are based on inputs, including forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace. Prices in Level 2 are either directly or indirectly observable as of the reporting date.
- Level 3 – Values are based on prices or valuation techniques that are not based on observable market data.

The fair value of cash and cash equivalents, restricted cash, accounts receivable, deposits and accounts payable and accrued liabilities approximate their carrying value due to the short term to maturity of these instruments.

The Company's financial derivatives liability and warrant liability are considered Level 2 in the fair value hierarchy.

iii) Credit risk

As at September 30, 2021, the carrying amount of cash and cash equivalents, restricted cash, accounts receivable and deposits represent the Company's maximum credit exposure. The Company's cash and cash equivalents are held on deposit with Canadian chartered banks.

Headwater's receivables from its crude oil and natural gas sales are subject to normal credit risk. During the nine months ended September 30, 2021, the Company sold its crude oil and natural gas production to various counterparties with one counterparty accounting for 71% of sales. Headwater mitigates the risk of loss by ensuring its major counterparties are investment grade as ranked by reputable credit agencies. Headwater historically has not experienced any collection issues. Payment of revenues from all counterparties occurs on the 25th day following the month of sale. As a result, the Company's production revenues are current.

Headwater's receivables from its joint venture partner are also subject to normal credit risk. Headwater has one joint venture partner, which is investment grade, in connection with its New Brunswick assets.

At September 30, 2021, 100% of the Company's accounts receivables were outstanding for less than 30 days. Trade receivables generally have a 30-day term and have all been collected subsequent to September 30, 2021. As at September 30, 2021, the Company's receivables consisted of $22,151 thousand (December 31, 2020 - $4,980 thousand) from crude oil and natural gas marketers, $45 thousand (December 31, 2020 - $237 thousand) from its joint venture partner and $45 thousand (December 31, 2020 - $258 thousand) related to accrued interest.

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company manages liquidity risk through its working capital surplus and an actively managed operating and capital expenditure budgeting process. As at September 30, 2021, the Company was holding cash and cash equivalents of $84.1 million.

The following table details the contractual maturities of the Company's liabilities as at September 30, 2021:

	Within 1 year	1 to 5 years
	$	$
Accounts payable and accrued liabilities	44,834	-
Financial derivatives liability	8,984	-
DSU liability	173	-
Lease liability	619	573
Total	54,610	573

b) Management of capital

The Company's objectives when managing capital are to i) deploy capital to provide an appropriate return on investment to its shareholders; ii) maintain financial flexibility in order to preserve the Company's ability to meet financial obligations; and iii) maintain a capital structure that provides financial flexibility to execute strategic acquisitions.

The Company's strategy is designed to maintain a flexible capital structure consistent with the objectives as stated above and to respond to changes in economic conditions and the risk characteristics of the underlying crude oil and natural gas assets. Headwater considers its capital structure to include shareholders' equity and working capital. In order to maintain or adjust its capital structure, the Company may from time to time issue new common shares, seek debt financing and adjust its capital spending to manage working capital.

In order to facilitate the management of its capital expenditures and working capital, the Company prepares annual budgets which are updated quarterly depending upon varying factors including current and forecast crude oil and natural gas prices, capital expenditures and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

Headwater has a development agreement under which the Company committed to spend $100 million in capital expenditures on certain oil and gas properties by December 31, 2022 unless otherwise extended by the counterparty. The Company expects to fund these expenditures through its working capital surplus and cash flows from operating activities. As at September 30, 2021, the remaining capital commitment is approximately $12 million.

The Company has not paid or declared any dividends.

14. RELATED PARTY TRANSACTION

Transactions with Cenovus

As at September 30, 2021, Cenovus owned approximately 25% of the Company's basic common shares outstanding and two of its senior officers were serving as directors of Headwater. Headwater and Cenovus have entered into a marketing agreement that terminates on December 2, 2023. As at September 30, 2021, a receivable of $22.0 million was recorded from Cenovus for September heavy oil sales which was subsequently collected. Subsequent to September 30, 2021, Cenovus sold all of the common shares of the Company that it held through a secondary offering. See note 16.

15. COMMITMENTS

a) Commitments

As at September 30, 2021, the Company is committed to future payments under the following agreements:

	Total	2021	2022	2023	2024	2025	Thereafter
	$	$	$	$	$	$	$
Transportation (1)	106,126	2,322	9,239	10,750	10,964	12,041	60,810
Capital commitment (2)	11,700	-	11,700	-	-	-	-
Total (3)	117,826	2,322	20,939	10,750	10,964	12,041	60,810

(1) At September 30, 2021, Headwater has the following transportation commitments:
   a. 10- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
   b. 10- year financial commitment at $1.9 million per year adjusted for inflation.
   c. 10- year take-or-pay transportation agreement with a current minimum volume commitment of 1,250 boe/d increasing to 6,250 boe/d in year 3 and to 9,000 boe/d in year 6.
   d. Take-or-pay agreement to January 2022 for minimum oil processing of 200 mboe per month.

(2) Refer to Note 13.

(3) Excludes leases accounted for under IFRS 16. Refer to note 5.

b) Letters of credit

As at September 30, 2021, the Company had a standby letter of credit issued by a Canadian chartered bank in the amount of $350 thousand relating to a transportation arrangement. The standby letter of credit is supported by cash which is recorded in restricted cash in the Statement of Financial Position.

16. SUBSEQUENT EVENTS

Financial derivative commodity and foreign exchange contracts

Subsequent to September 30, 2021, Headwater entered into the following financial derivative commodity and foreign exchange contracts:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT	Fixed	Dec 2021	2,500 mmbtu	US$17.00/mmbtu
Natural Gas	AGT	Fixed	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$25.26/mmbtu

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, October 2021 average	US$11,300,000	November 26, 2021
Forward contract	CAD	USD	WMR noon rate, November 2021 average	US$19,000,000	December 27, 2021

Secondary offering

On October 14, 2021, Cenovus closed a $227.5 million bought deal secondary offering of the Company’s common shares. Post-closing of the offering, Cenovus no longer holds any of Headwater’s common shares and as a result, the investor agreement (the "Investor Agreement") between Cenovus and Headwater was terminated in accordance with its terms. In connection with the termination of the Investor Agreement, one of Cenovus' nominees on the Board of Directors of the Company resigned. The other nominee of Cenovus on the Board of Directors of the Company will continue to serve as a director of the Company notwithstanding the termination of the Investor Agreement. Headwater did not receive any proceeds of the secondary offering. Cenovus continues to hold 15,000,000 Cenovus Warrants exercisable at $2.00 per common share until December 2, 2023. See note 7.