

HEADWATER EXPLORATION INC.

Interim Condensed Statements of Financial Position

(unaudited)

	June 30 2021	December 31 2020
<i>(thousands)</i>	\$	\$
ASSETS		
Current assets		
Cash and cash equivalents	79,923	76,772
Restricted cash (notes 13 & 15)	350	1,827
Accounts receivable (note 13)	15,644	5,475
Financial derivatives receivable (note 13)	119	74
Inventories	333	571
Prepays and deposits	650	448
Total current assets	97,019	85,167
Exploration and evaluation assets (note 3)	27,855	27,101
Property, plant and equipment (note 4)	227,045	187,664
Right-of-use assets (note 5)	430	418
Other assets	335	335
Total assets	352,684	300,685
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 13)	26,820	4,105
Financial derivatives liability (note 13)	1,757	-
Deferred share units liability (note 9)	166	91
Current portion of lease liability (note 5)	217	138
Warrant liability (note 7)	35,473	10,305
Total current liabilities	64,433	14,639
Lease liability (note 5)	248	298
Decommissioning liability (note 6)	19,812	16,718
Total liabilities	84,493	31,655
Shareholders' Equity		
Capital stock (note 8)	395,870	387,393
Warrants (note 8)	5,512	7,659
Contributed surplus	12,695	11,659
Deficit	(145,886)	(137,681)
Total shareholders' equity	268,191	269,030
Total liabilities and shareholders' equity	352,684	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 June 30,		Six months ended June 30,	
	2021	2020	2021	2020
<i>(thousands, except per share data)</i>	\$	\$	\$	\$
REVENUE				
Sales (note 10)	40,038	565	65,530	2,873
Royalties	(5,351)	(15)	(7,706)	(72)
Revenue, net of royalties	34,687	550	57,824	2,801
Gains (losses) on financial derivatives (note 13)	(1,312)	149	(2,117)	2,605
	33,375	699	55,707	5,406
EXPENSES				
Blending and transportation	7,579	-	12,538	-
Production	2,960	534	5,373	1,181
General and administrative	971	842	1,818	1,525
Transaction costs	-	-	-	4,382
Remeasurement loss on warrant liability (note 7)	5,973	-	25,168	-
Stock-based compensation expense (note 9)	610	429	1,130	410
Depletion and depreciation (notes 4 & 5)	10,459	754	17,709	3,259
Exploration and evaluation expense (note 3)	-	-	-	3,821
	28,552	2,559	63,736	14,578
Interest income and other (note 11)	(235)	181	(176)	683
Net income (loss) and comprehensive income (loss)	4,588	(1,679)	(8,205)	(8,489)
Net income (loss) per share (note 8)				
Basic and diluted	0.02	(0.01)	(0.04)	(0.07)

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: (thousands)	Three months ended June 30, 2021	2020	Six months ended June 30, 2021	2020
	\$	\$	\$	\$
OPERATING				
Net income (loss)	4,588	(1,679)	(8,205)	(8,489)
Items not involving cash:				
Unrealized (gains) losses on financial derivatives (note 13)	1,458	(149)	1,712	1,332
Remeasurement loss on warrant liability	5,973	-	25,168	-
Stock-based compensation expense	610	429	1,130	410
Depletion and depreciation	10,459	754	17,709	3,259
Exploration and evaluation expense	-	-	-	3,821
Accretion and finance charges (note 11)	94	35	147	88
Change in non-cash operating working capital (note 12)	50	1,473	(1,646)	1,624
Cash flows provided by operating activities	23,232	863	36,015	2,045
FINANCING				
Issue of common shares, net of costs (note 8)	-	-	-	48,096
Payment of lease liability (note 5)	(36)	(36)	(72)	(73)
Proceeds from exercise of stock options & Warrants (note 8)	5,163	409	5,547	2,079
Cash flows provided by financing activities	5,127	373	5,475	50,102
INVESTING				
Capital expenditures – property, plant and equipment (note 4)	(16,305)	(59)	(53,299)	(124)
Capital expenditures – exploration and evaluation (note 3)	(476)	(339)	(754)	(344)
Change in restricted cash	240	300	1,477	300
Change in non-cash investing working capital (note 12)	(13,538)	19	14,237	(145)
Cash flows used in investing activities	(30,079)	(79)	(38,339)	(313)
Change in cash and cash equivalents	(1,720)	1,157	3,151	51,834
Cash and cash equivalents, beginning of period	81,643	111,634	76,772	60,957
Cash and cash equivalents, end of period	79,923	112,791	79,923	112,791

See accompanying notes to the interim condensed financial statements

HEADWATER EXPLORATION INC.

Interim Condensed Statements of Changes in Shareholders' Equity

(unaudited)

	Notes	Capital stock	Warrants	Contributed surplus	Deficit	Total Shareholders' equity
<i>(thousands)</i>		\$	\$	\$	\$	\$
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	-	-	391	-	391
Net loss		-	-	-	(8,489)	(8,489)
Balance at June 30, 2020		290,946	7,680	10,637	(152,877)	156,386
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	7,676	(2,147)	-	-	5,529
Stock-based compensation	9	-	-	1,819	-	1,819
Net loss		-	-	-	(8,205)	(8,205)
Balance at June 30, 2021		395,870	5,512	12,695	(145,886)	268,191

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 six months ended June 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 August 5, 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 June 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:

	June 30, 2021	December 31, 2020
	\$	\$
Balance, beginning of period	27,101	3,816
Acquired - property acquisition	-	26,637
Additions	754	469
Expensed	-	(3,821)
Balance, end of period	27,855	27,101

The Company concluded there are no indicators of impairment for its E&E assets at June 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	54,052	10	54,062
Changes in decommissioning liabilities	2,955	-	2,955
Balance at June 30, 2021	505,728	2,749	508,477
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	17,597	39	17,636
Balance at June 30, 2021	279,242	2,190	281,432
Net book value at December 31, 2020	187,076	588	187,664
Net book value at June 30, 2021	226,486	559	227,045

As at June 30, 2021, the calculation of depletion includes estimated future development costs relating to the development of proved plus probable reserves of \$38.2 million (December 31, 2020 – proved plus probable

reserves of \$48.0 million).

The Company capitalized \$555 thousand of general and administrative costs for the six months ended June 30, 2021 (year ended December 31, 2020 – \$80 thousand) and capitalized stock-based compensation expense of \$764 thousand for the six months ended June 30, 2021 (year ended December 31, 2020 – \$nil).

Q2 2021 Impairment Assessment

At June 30, 2021, there were no indicators of impairment or reversal of impairment identified. As such, an impairment test was not performed.

5. LEASES

Right-of-use assets

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

Cost	Office and equipment leases	Surface rentals	Vehicles	Total
	\$	\$	\$	\$
Balance at December 31, 2019	170	174	89	433
Additions	289	-	-	289
Dispositions	-	-	(89)	(89)
Balance at December 31, 2020	459	174	-	633
Additions	93	-	-	93
Balance at June 30, 2021	552	174	-	726
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	81	-	-	81
Balance at June 30, 2021	280	16	-	296
Net book value as at December 31, 2020	260	158	-	418
Net book value as at June 30, 2021	272	158	-	430

Lease liability

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

	June 30, 2021	December 31, 2020
	\$	\$
Lease liability, beginning of period	436	285
Additions	93	288
Dispositions	-	(38)
Interest expense	8	11
Payment of lease liability	(72)	(110)
Lease liability, end of period	465	436

Current portion of lease liability	217	138
Non-current portion of lease liability	248	298
Total lease liability	465	436

During the six months ended June 30, 2021, the weighted average discount rate used was 5.0%.

6. DECOMMISSIONING LIABILITY

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

	June 30, 2021	December 31, 2020
	\$	\$
Balance, beginning of period	16,718	11,976
Acquired - property acquisition	-	1,709
Additions	4,560	50
Change in estimate ⁽¹⁾	(1,605)	606
Accretion	139	149
Revaluation of liabilities acquired	-	2,228
Balance, end of period	19,812	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 1.8% at June 30, 2021 results in a decrease to the decommissioning liability of \$2.7 million and the change in inflation rate from 1.5% at December 31, 2020 to 1.7% at June 30, 2021 results in an increase to the decommissioning liability of \$1.1 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 \$19.8 million as at June 30, 2021 (December 31, 2020 - \$16.7 million). The total future undiscounted amount of estimated cash flows required to settle these obligations is \$31.6 million (December 31, 2020 - \$23.6 million). Management estimates the settlement of these obligations will occur over the next 17 to 32 years. At June 30, 2021, a risk-free rate of 1.8% (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:

	June 30, 2021	December 31, 2020
	\$	\$
Warrant liability, beginning of period	10,305	-
Issued - acquisition	-	6,016
Remeasurement loss on warrant liability	25,168	4,289
Warrant liability, end of period	35,473	10,305

As at June 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 June 30, 2021 and on December 31, 2020 was determined using a Monte Carlo simulation pricing model with the following inputs:

	June 30, 2021	December 31, 2020
Share price	\$4.36	\$2.39
Risk-free interest rate	0.6%	0.3%
Expected life (years) ⁽¹⁾	0.4	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

	June 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	6,064	7,676	62	79
Balance, end of period	202,286	395,870	195,106	387,393

Stock Options

During the six months ended June 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 six months ended June 30, 2021, 6,077 thousand Warrants were exercised for 6,064 thousand common shares. The associated fair value of the Warrants of \$2,147 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 June 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

	June 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	(6,077)	(2,147)	(62)	(21)
Balance, end of period	15,600	5,512	21,677	7,659

As at June 30, 2021, there were 15.6 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 June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Weighted average shares outstanding				
Basic	197,445	144,749	196,389	125,401
Diluted	213,905	144,749	196,389	125,401

In computing the diluted weighted average shares outstanding for the three months ended June 30, 2021, 8,062,438 warrants issued to Cenovus were excluded as they were anti-dilutive.

As the Company incurred a net loss for the six months ended June 30, 2021, in computing the diluted weighted average shares outstanding for the six months ended June 30, 2021, 3,840,928 stock options, 11,917,566 warrants and 7,302,008 warrants issued to Cenovus were excluded from the calculation 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:

	Six months ended June 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	3,014	\$ 4.17	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	9,496	\$ 2.26	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 six months ended June 30, 2021 was \$4.49 per common share (six months ended June 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:

	June 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 six months ended June 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 June 30, 2021 is as follows:

Exercise prices	Outstanding options			Exercisable options	
	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	541	2.66	\$ 0.93	54	\$ 0.71
\$ 1.01 - \$ 2.00	4,330	2.74	\$ 1.06	696	\$ 1.06
\$ 2.01 - \$ 3.00	2,290	3.48	\$ 2.50	-	-
\$ 3.01 - \$4.66	2,335	3.70	\$ 4.57	-	-
Total	9,496	3.15	\$ 2.26	750	\$ 1.04

For the six months ended June 30, 2021, the Company recorded stock-based compensation expense of \$1.0 million and capitalized stock-based compensation expense of \$764 thousand with a corresponding increase to contributed surplus of \$1.8 million with respect to stock options (six months ended June 30, 2020 - \$391 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:

	June 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	-	75	-	304
DSUs, end of period	38	166	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 June 30, 2021 of \$166 thousand is based on a fair value of \$4.36 per DSU which is the Company's closing share price on June 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 June 30,		Six months ended June 30,	
	2021	2020	2021	2020
	\$	\$	\$	\$
Heavy oil	39,257	-	58,412	-
Natural gas sales	566	491	6,284	2,500
Gathering, processing and transportation	184	74	772	336
Natural gas liquids sales	31	-	62	37
	40,038	565	65,530	2,873

The Company's heavy oil, natural gas and NGL revenues for the six months ended June 30, 2021 were

primarily derived from variable priced contracts based on index prices.

Included in accounts receivable as at June 30, 2021 is \$15.2 million (December 31, 2020 - \$4.5 million) of accrued sales related to June 2021 production.

11. INTEREST INCOME AND OTHER

Interest income and other consist of the following:

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
	\$	\$	\$	\$
Interest income	146	262	350	620
Foreign exchange gains (losses)	(287)	(44)	(379)	154
Accretion	(89)	(35)	(139)	(88)
Interest on lease liability	(5)	(2)	(8)	(3)
	(235)	181	(176)	683

12. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
	\$	\$	\$	\$
Change in non-cash operating working capital:				
Accounts receivable	(2,434)	1,987	(10,169)	2,492
Inventories	117	-	247	-
Prepays and deposits	(163)	(148)	(202)	(293)
Accounts payable and accrued liabilities	2,530	(366)	8,478	(575)
	50	1,473	(1,646)	1,624
Change in non-cash investing working capital:				
Accounts payable and accrued liabilities	(13,538)	19	14,237	(145)
	(13,538)	19	14,237	(145)

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 receivable/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 June 30, 2021:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT Basis ^{(1) (2)}	Differential	Dec 1- Mar 31, 2022	2,500 mmbtu	Cdn\$4.16/mmbtu
Natural Gas	AGT Basis ⁽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	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

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 financial derivatives gains (losses) are reflected in the Statements of Loss:

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
	\$	\$	\$	\$
Gains (losses) on financial derivatives:				
- realized gains (losses)	146	-	(405)	3,937
- unrealized gains (losses)	(1,458)	149	(1,712)	(1,332)
Gains (losses) on financial derivatives	(1,312)	149	(2,117)	2,605

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

	Commodity contracts	Foreign exchange contracts	Total
	\$	\$	\$
Net financial derivatives receivable	74	-	74
Unrealized change in fair value	(1,623)	(89)	(1,712)
Net financial derivatives liability	(1,549)	(89)	(1,638)

The fair value of the net financial derivatives liability related to the Company's commodity contracts of \$1.5 million as at June 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 net financial derivatives payable would increase (decrease) by \$911 thousand.

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 June 30, 2021:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, June 2021 average ⁽¹⁾	USD\$4,600,000	July 26, 2021

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

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

<i>(thousands of U.S. dollars)</i>	June 30, 2021	December 31, 2020
Cash	\$ 220	\$ 7
Accounts receivable	4,991	1,031
Financial instruments in U.S. dollars	5,211	1,038

At June 30, 2021, a 5% decrease in the CAD\$/USD\$ exchange rate would have resulted in an increase of approximately \$38 thousand to the Company's net loss (June 30, 2020 – \$2 thousand increase to net loss). Conversely, a 5% increase in the CAD\$/USD\$ exchange rate would have resulted in a decrease of approximately \$38 thousand in the Company's net loss (June 30, 2020 – \$2 thousand decrease in net loss).

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 receivable/liability and warrant liability are considered Level 2 in the fair value hierarchy.

iii) Credit risk

As at June 30, 2021, the carrying amount of cash and cash equivalents, restricted cash, accounts receivable,

deposits and financial derivatives receivable 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 six months ended June 30, 2021, the Company sold its crude oil and natural gas production to various counterparties with one counterparty accounting for 62% 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 June 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 June 30, 2021. As at June 30, 2021, the Company's receivables consisted of \$15,550 thousand (December 31, 2020 - \$4,980 thousand) from crude oil and natural gas marketers, \$53 thousand (December 31, 2020 - \$237 thousand) from its joint venture partner and \$41 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 June 30, 2021, the Company was holding cash and cash equivalents of \$79.9 million.

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

	Within 1 year	1 to 5 years
	\$	\$
Accounts payable and accrued liabilities	26,820	-
Financial derivatives liability	1,757	-
DSU liability	166	-
Lease liability	217	248
Total	28,960	248

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 June 30, 2021, the remaining capital commitment is approximately \$47 million.

The Company has not paid or declared any dividends.

14. RELATED PARTY TRANSACTION

Transactions with Cenovus

As at June 30, 2021, Cenovus owned 25% of the Company's basic common shares outstanding and two of its senior officers serve as directors of Headwater. Headwater and Cenovus have entered into a marketing agreement that terminates on December 2, 2023. As at June 30, 2021, a receivable of \$6.1 million was recorded from Cenovus for June heavy oil sales.

15. COMMITMENTS

a) Commitments

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

	Total	2021	2022	2023	2024	2025	Thereafter
	\$	\$	\$	\$	\$	\$	\$
Transportation ⁽¹⁾	107,440	3,777	9,098	10,750	10,964	12,041	60,810
Capital commitment ⁽²⁾	47,240	-	46,800	440	-	-	-
Total ⁽³⁾	154,680	3,777	55,898	11,190	10,964	12,041	60,810

- (1) At June 30, 2021, Headwater has the following transportation commitments:
- 10- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
 - 10- year financial commitment at \$1.9 million per year adjusted for inflation.
 - 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.
- (2) Refer to Note 13. An additional capital commitment was executed in 2021 whereby Headwater has committed to drill one Clearwater exploratory well before March 2023; if Headwater does not drill the well, it must pay \$440 thousand.
- (3) Excludes leases accounted for under IFRS 16. Refer to note 5.

b) Letters of credit

As at June 30, 2021, the Company had a standby letter of credit issued by a Canadian chartered bank in the amounts 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

Subsequent to June 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	Nov 2021	2,500 mmbtu	Cdn\$5.71/mmbtu
Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, July 2021 average	USD\$7,200,000	August 26, 2021
Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, August 2021 average	USD\$9,400,000	September 27, 2021