

Q1 2024 Management's Discussion and Analysis

The following management's discussion and analysis ("MD&A") as provided by the management of Headwater Exploration Inc. ("Headwater" or the "Company") is dated May 9, 2024 and should be read in conjunction with the unaudited interim condensed financial statements as at and for the three months ended March 31, 2024, and the MD&A and the audited financial statements and the notes thereto for the year ended December 31, 2023, copies of which are available through SEDAR+ at www.sedarplus.ca. The unaudited interim condensed financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting* as issued by the International Accounting Standards Board ("IASB"). All dollar amounts are referenced in Canadian dollars unless otherwise stated.

Description of the Company

Headwater is a Canadian resource company engaged in the exploration for and development and production of petroleum and natural gas in Canada. Headwater currently has heavy oil production and reserves in the Clearwater/Falher formations in the Marten Hills, Greater Nipisi and Greater Peavine areas of Alberta and natural gas production and reserves in the McCully field near Sussex, New Brunswick. In 2023, Headwater began accumulating a significant land position outside of the Clearwater/Falher acreage across Western Canada. During the three months ended March 31, 2024, the Company drilled its first stratigraphic test and single-leg horizontal well, prospective for heavy oil, in Handel, Saskatchewan, with first sales realized in the second quarter of 2024.

Unless otherwise indicated herein, all production information presented herein has been presented on a gross basis, which is the Company's working interest prior to deduction of royalties and without including any royalty interests.

HIGHLIGHTS FOR THREE MONTHS ENDED MARCH 31, 2024

- Production averaged 19,517 boe/d (consisting of 17,512 bbls/d of heavy oil, 11.5 mmcf/d of natural gas and 87 bbls/d of natural gas liquids) representing an increase of 15% from the first quarter of 2023.
- Realized adjusted funds flow from operations ⁽¹⁾ of \$76.4 million (\$0.32 per share basic ⁽²⁾) and cash flows from operations of \$55.0 million (\$0.23 per share basic).
- Achieved an operating netback inclusive of financial derivatives ⁽²⁾ of \$50.65/boe and an adjusted funds flow netback ⁽²⁾ of \$43.17/boe.
- Achieved net income of \$37.6 million (\$0.16 per share basic) equating to \$21.24/boe.
- Executed a \$65.3 million capital expenditure ⁽³⁾ program inclusive of \$11.7 million on land expenditures adding 81.4 net sections. The Company drilled 20 net crude oil wells at a 100% success rate.
- Declared a cash dividend of \$23.7 million, or \$0.10 per common share.
- As at March 31, 2024, Headwater had adjusted working capital ⁽¹⁾ of \$48.8 million, working capital of \$58.3 million, and no outstanding bank debt.

(1) Capital management measure that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Management of capital" in note 12 of the interim financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.

(2) Non-GAAP ratio that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

(3) Non-GAAP financial measure that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

Results of Operations

Production and Pricing

	Three months ended March 31,		Percent Change
	2024	2023	
Average daily production			
Heavy oil (bbls/d)	17,512	14,777	19
Natural gas (mmcf/d)	11.5	12.8	(10)
Natural gas liquids (bbls/d)	87	91	(4)
Barrels of oil equivalent (boe/d)	19,517	17,004	15
Average daily sales ⁽¹⁾			
Heavy oil (bbls/d)	17,454	14,741	18
Natural gas (mmcf/d)	11.5	12.8	(10)
Natural gas liquids (bbls/d)	87	91	(4)
Barrels of oil equivalent (boe/d)	19,459	16,968	15
Headwater average sales price ⁽²⁾			
Heavy oil (\$/bbl) ⁽³⁾	76.04	65.41	16
Natural gas (\$/mcf)	5.03	5.58	(10)
Natural gas liquids (\$/bbl)	70.69	66.53	6
Barrels of oil equivalent (\$/boe)	71.49	61.40	16
Average Benchmark Price			
WTI (US\$/bbl) ⁽⁴⁾	76.96	76.13	1
WCS differential to WTI (US\$/bbl)	(19.31)	(24.77)	(22)
WCS (Cdn\$/bbl) ⁽⁵⁾	77.77	69.45	12
Condensate at Edmonton (Cdn\$/bbl)	97.36	105.88	(8)
AGT (US\$/mmbtu) ⁽⁶⁾	4.26	5.13	(17)
AECO 5A (Cdn\$/GJ)	2.37	3.05	(22)
NYMEX Henry Hub (US\$/mmbtu)	2.24	3.42	(35)
Exchange rate (Cdn\$/US\$)	0.74	0.74	-

(1) Includes sales of heavy crude oil excluding the impact of purchased condensate and butane. The Company's heavy oil sales volumes and production volumes differ due to changes in inventory.

(2) Average sales prices are calculated using average sales volumes.

(3) Realized heavy oil prices are based on sales, net of blending expense.

(4) WTI = West Texas Intermediate.

(5) WCS = Western Canadian Select.

(6) AGT = Algonquin city-gates. The AGT price is the average for the winter producing months in the McCully field which include January to April, November and December.

	Three months ended March 31,		Percent Change
	2024	2023	
	<i>(thousands of dollars)</i>		
Heavy oil sales	127,446	96,422	32
Blending expense	(6,668)	(9,639)	(31)
Heavy oil, net of blending ⁽¹⁾	120,778	86,783	39
Natural gas	5,267	6,437	(18)
Natural gas liquids	557	546	2
Gathering, processing and transportation	764	804	(5)
Total sales, net of blending expense ⁽¹⁾	127,366	94,570	35

(1) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

Heavy Oil – Alberta

The Company's realized price received for its heavy crude oil is determined by the quality of crude compared to the benchmark price of WCS. Headwater's heavy crude oil production (average 18 – 22° API) is blended with diluent in order to meet pipeline transportation specifications.

The WTI price and the Cdn\$/US\$ foreign exchange rate were consistent over the periods, while the WCS differential to WTI narrowed during the three months ended March 31, 2024, due to increased North American demand and improved egress out of Western Canada. Headwater's discount to WCS also narrowed during the first quarter of 2024 primarily due to blending optimization and stronger realized pricing relative to WCS.

During the three months ended March 31, 2024, Headwater's heavy oil sales, net of blending expense, increased to \$120.8 million from \$86.8 million in the corresponding period of 2023. This increase was attributable to a 16% increase in realized commodity pricing, relatively consistent with the increase in benchmark WCS pricing, combined with an 18% increase in sales volumes.

During the three months ended March 31, 2024, Headwater's heavy oil sales volumes averaged 17,454 bbls/d compared to 14,741 bbls/d in the corresponding period of 2023. The Company's heavy oil sales volumes have increased as a result of Headwater's growth-oriented drilling program. Headwater drilled 90.0 total net crude oil wells during the year ended December 31, 2023, and drilled 20.0 total net crude oil wells in the first quarter of 2024, increasing the Company's heavy oil production.

Natural Gas – New Brunswick and Alberta

The Company produces natural gas out of the McCully field in New Brunswick. The transaction price is based on the AGT daily benchmark price adjusted for delivery location and heat content. Headwater also produces natural gas in Alberta, as the Company commissioned its Marten Hills joint gas processing facility and started generating sales from its associated natural gas production in the third quarter of 2021. The natural gas sales transaction price is based on the AECO 5A daily benchmark price adjusted for delivery location and heat content.

Both AGT and AECO 5A saw a decrease in pricing over the period due to increasing storage levels resulting from the current El Nino climate pattern. Natural gas inventories are currently at the top of the historical five-year average in both the northeastern United States and Western Canada.

For the three months ended March 31, 2024, Headwater's natural gas sales decreased to \$5.3 million from \$6.4 million in the corresponding period of the prior year, due to a 10% decrease in realized commodity pricing and a 10% decrease in natural gas sales volumes. Realized natural gas pricing decreased due to lower benchmark pricing for both AGT and AECO 5A.

During the three months ended March 31, 2024, Headwater's natural gas sales volumes decreased to 11.5 mmcf/d from 12.8 mmcf/d in the corresponding period of the prior year as a result of lower natural gas production out of Alberta as Headwater realized declining natural gas production in the core area of Marten Hills.

Consistent with prior years, the Company shut-in McCully natural gas production for the upcoming summer season effective May 1, 2024.

Financial Derivative Gains (Losses)

	Three months ended March 31,		Percent Change
	2024	2023	
	<i>(thousands of dollars)</i>		
Realized gains	6,114	7,240	(16)
Unrealized gains (losses)	(5,841)	2,003	(392)
Financial derivative gains	273	9,243	(97)
Per boe (\$)	0.15	6.05	(98)

Natural gas and crude oil commodity contracts

Headwater enters into financial derivative commodity contracts to manage the risks associated with fluctuations in commodity prices.

The realized financial derivative gains recognized during the three months ended March 31, 2024, represent the natural gas contracts referenced to the AGT price. A realized financial derivative gain of \$6.1 million was recorded during the three months ended March 31, 2024 compared to a realized gain of \$7.2 million in the corresponding period of 2023. The Company recognized gains on its AGT contracts during the three months ended March 31, 2024, as the commodity contracts to fix the AGT price exceeded the settlement price in the period. The AGT settlement price was lower than expected due to warmer winter weather experienced in the northeastern US natural gas market resulting in significantly reduced natural gas demand in the area.

The unrealized gains recorded are a result of the change in fair value of the Company's outstanding financial derivative contracts over the periods. As at March 31, 2024, the fair value of Headwater's outstanding financial derivative commodity contracts was a net unrealized liability of \$2.2 million as reflected in the interim condensed financial statements. The fair value or mark to market value of these contracts is based upon the estimated amount that would have been payable as at March 31, 2024, had the contracts been monetized or terminated. Subsequent changes in the fair value of the contracts are recognized in each reporting period and could be materially different than what is recorded as at March 31, 2024. For the three months ended March 31, 2024, Headwater recognized unrealized losses of \$5.8 million compared to unrealized gains of \$2.0 million in the corresponding period of 2023.

As at March 31, 2024, Headwater had the following financial derivative commodity contracts outstanding:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AECO 5A	Fixed	April 2024 - Oct 2024	2,000 GJ	Cdn\$2.12/GJ
Natural Gas	AECO 5A	Fixed	April 2025 - Oct 2025	2,000 GJ	Cdn\$2.78/GJ
Natural Gas	AGT	Fixed	April 2024	2,500 mmbtu	Cdn\$2.33/mmbtu
Natural Gas	AGT	Fixed	Dec 2024 - Mar 2025	2,500 mmbtu	Cdn\$10.65/mmbtu
Crude Oil	WCS Basis	Differential	Apr 2024 - Jun 2024	5,000 bbl	US\$15.18/bbl
Crude Oil	WCS Basis	Differential	Jul 2024 - Sep 2024	3,000 bbl	US\$13.25/bbl

Foreign exchange contracts

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 short-term foreign exchange contracts.

As at March 31, 2024, Headwater had the following financial derivative foreign exchange contract outstanding:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	March 2024 average ⁽¹⁾	US\$0.5 million	April 26, 2024

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

(2) Unrealized change in fair value related to the Company's foreign exchange contracts is included in interest income and other expense in the interim financial statements.

Royalty Expense

	Three months ended March 31, 2024 2023 (thousands of dollars)		Percent Change
Royalty expense	21,844	15,332	42
Percentage of total sales, net of blending ⁽¹⁾	17.2%	16.2%	6
Per boe (\$)	12.34	10.04	23

(1) Non-GAAP ratio. Refer to the advisory "Non-GAAP and Other Financial Measures".

Royalty expense primarily consists of crown royalties payable to the Alberta and New Brunswick provincial governments and the gross overriding royalty ("GORR") payable to Topaz Energy Corp. Under the Alberta Modernized Royalty Framework, the Company will pay a flat royalty of 5% on a well's production until the well's total revenue exceeds the drilling and completion cost allowance, then royalty rates increase on a sliding scale up to 40% depending on commodity reference pricing.

For the three months ended March 31, 2024, royalty expense increased to \$21.8 million from \$15.3 million in the corresponding period of 2023, representing an increase of 42% which is relatively consistent with the increase in total sales (net of blending expense) over the period, of 35%. Also contributing to the increase in royalty expense is an increase in the royalty rate over the period from 16.2% to 17.2% which was driven by an increase in realized heavy oil commodity pricing.

Transportation Expense

	Three months ended March 31, 2024 2023 (thousands of dollars)		Percent Change
Transportation expense	9,468	8,397	13
Per boe (\$)	5.35	5.50	(3)

Transportation expense includes clean oil trucking, terminal fees and pipeline tariffs incurred to move production to the sales point.

For the three months ended March 31, 2024, transportation expense increased to \$9.5 million from \$8.4 million in the corresponding period of the prior year as a result of an increase to heavy oil sales volumes.

Transportation expense per boe was consistent over the periods.

Headwater has firm transportation service commitments in place to secure pipeline capacity to the point of sale. Refer to “Contractual Obligations and Commitments” for more information.

Production Expense

	Three months ended March 31,		Percent Change
	2024	2023	
	(thousands of dollars)		
Production expense	12,459	9,979	25
Per boe (\$)	7.04	6.53	8

Production expense in the three months ended March 31, 2024, was \$12.5 million compared to \$10.0 million in the corresponding period of 2023. The increase in production expense reflects the increase in the Company’s production volumes over the period.

For the three months ended March 31, 2024, production expense per boe increased to \$7.04 from \$6.53 in the corresponding period of the prior year due to substantial growth in Marten Hills West and the development of new areas in Greater Nipisi and Greater Peavine which carry higher operating costs than the initial development area of Marten Hills.

Netbacks

Operating netback reflects the Company’s margin on a per-barrel of oil equivalent basis. The following table provides a reconciliation of Headwater’s operating netback and operating netback, including financial derivatives. Refer to the heading “Non-GAAP and Other Financial Measures” for more information.

	Three months ended March 31,		Percent Change
	2024	2023	
	(\$/boe)		
Sales	75.69	68.24	11
Royalties	(12.34)	(10.04)	23
Transportation and blending	(9.11)	(11.81)	(23)
Production expense	(7.04)	(6.53)	8
Operating netback ⁽¹⁾	47.20	39.86	18
Realized gains on financial derivatives	3.45	4.74	(27)
Operating netback, including financial derivatives ⁽¹⁾	50.65	44.60	14

(1) Non-GAAP ratio. Refer to the advisory “Non-GAAP and Other Financial Measures”.

For the three months ended March 31, 2024, the Company’s operating netback, including financial derivatives increased to \$50.65 per boe, from \$44.60 per boe in the corresponding period of 2023, as a result of higher realized commodity pricing and lower transportation and blending, partially offset by higher royalties and production expense and lower realized gains on financial derivatives.

General and Administrative (“G&A”) Expenses

	Three months ended March 31, 2024 2023 <i>(thousands of dollars)</i>		Percent Change
G&A expenses	3,645	2,904	26
Capitalized G&A	(1,044)	(841)	24
Net G&A expenses	<u>2,601</u>	<u>2,063</u>	26
Per boe (\$)	1.47	1.35	9

For the three months ended March 31, 2024, net G&A expenses increased to \$2.6 million from \$2.1 million in the corresponding period of 2023. Increased net G&A expenses on an absolute and per boe basis were mainly a result of increased employee related costs due to the growth experienced by the Company over the period.

Interest Income and Other Expense

	Three months ended March 31, 2024 2023 <i>(thousands of dollars)</i>		Percent Change
Interest income	1,671	1,788	(7)
Realized and unrealized foreign exchange gains (losses)	33	(3)	(1200)
Accretion on decommissioning liability	(309)	(262)	18
Interest on repayable contribution	(214)	(117)	83
Interest on lease liability	(15)	(10)	50
Total interest income and other expense	<u>1,166</u>	<u>1,396</u>	(16)
Per boe (\$)	0.66	0.91	(27)

For the three months ended March 31, 2024, interest income and other expense decreased to \$1.2 million from \$1.4 million in the corresponding period of the prior year due to lower interest income and higher accretion on decommissioning liability and interest on repayable contribution. The slight decrease in interest income for the three months ended March 31, 2024 is a result of carrying a lower average cash balance when compared to the same period in 2023. Interest on repayable contribution has increased due to the receipt of two additional grants in late 2023.

The Company manages fluctuations in foreign exchange gains and losses by entering into foreign exchange contracts to fix the foreign exchange rate. Refer to “Financial Derivatives Gains (Losses)” for more information.

Stock-Based Compensation

	Three months ended March 31,		Percent Change
	2024	2023	
	<i>(thousands of dollars)</i>		
Stock options	149	509	(71)
Deferred share units	1,215	665	83
Share awards	1,759	787	124
Capitalized stock-based compensation	(400)	(346)	16
Stock-based compensation	<u>2,723</u>	<u>1,615</u>	69
Per boe (\$)	1.54	1.06	45

During the three months ended March 31, 2024, stock-based compensation expense increased to \$2.7 million from \$1.6 million in the corresponding period of the prior year. The higher expense associated with deferred share units (“DSUs”) and share awards was due to new grants in the period and an increase in the Company’s share price to \$7.67 at March 31, 2024, from \$6.25 at December 31, 2023. The expense for stock options was lower due to the majority of outstanding stock options being fully vested.

Share Awards

The Company’s performance and restricted award plan (“Award Plan”) provides for the grant of restricted share units (“RSUs”) and performance share units (“PSUs”) to officers, employees and consultants of the Company. Under the Award Plan, the aggregate number of common shares reserved for issuance may not exceed the lesser of: (i) 6.0% of the aggregate number of issued and outstanding common shares less the aggregate number of common shares reserved for issuance under the Company’s stock option plans; and (ii) 4.5% of the aggregate number of issued and outstanding common shares. Generally, one third of the RSUs will vest on each of the first, second and third anniversaries of the date of grant and all PSUs will vest on the third anniversary of the date of grant, unless otherwise determined by the Board of Directors of the Company (the “Board”). The common shares underlying PSUs are adjusted based on a performance multiplier ranging from 0 to 2 times, which is determined based on certain corporate performance measures, as determined by the Board.

During the year ended December 31, 2023, the Board approved the cash settlement of RSUs. Previously, these Awards had been accounted for as equity-settled. As a result of this modification to the Company’s outstanding RSUs from equity-settled to cash-settled, the fair value of the awards previously expensed was reclassified from contributed surplus to stock-based compensation payable. Subsequent to this modification, the grant date fair value is used to record the cost of the RSUs and any subsequent remeasurement of the liability is also recognized in the Statement of Income and Comprehensive Income.

It is the intention of the Company to equity settle any outstanding PSUs. The Award Plan allows a holder to receive common shares upon vesting. Headwater uses the fair value method for valuing the PSUs. The fair value of PSUs is determined based on the volume weighted average trading price of the five days preceding the grant date. This fair value is recognized as stock-based compensation expense, with a portion being capitalized, over the vesting period with a corresponding increase to contributed surplus. The amount of stock-based compensation expense is reduced by an estimated forfeiture rate determined at the date of the grant and updated each period. Upon vesting of the PSUs and settlement in common shares, the previously recognized value in contributed surplus will be recorded as an increase to capital stock.

As at March 31, 2024, there were 462,803 RSUs outstanding and 2,744,817 PSUs outstanding.

Deferred Share Units

The deferred share unit plan (“DSU Plan”) provides for grants of DSUs to non-management directors. Each DSU vests on the date of grant; however, settlement of the DSU occurs when the individual ceases to be

a director of the Company. DSUs are to be settled in cash or by payment in common shares acquired through the facilities of the Toronto Stock Exchange (“TSX”). It is the intention of the Company to settle the DSUs in cash. The directors may also elect to receive all of their annual cash compensation in the form of DSUs provided that such election must be made on December 1st of the preceding calendar year (or within a certain prescribed time frame if an individual becomes a director after the commencement of a calendar year or after the initial adoption of the DSU Plan) and after such date the election will be irrevocable for such year. DSUs are measured at fair value using the Company’s closing share price on March 31, 2024.

As at March 31, 2024, there were 365,507 DSUs outstanding.

Stock Options

The Company has an old and new stock option plan (the “Option Plans”) under which options to purchase common shares of the Company could be granted to directors, officers, employees and consultants of the Company. The exercise price of each option granted 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 generally vest as to one third of the number granted on each of the first, second and third anniversaries of the date of grant over a three-year period and expire four to five years after the grant date. The Company did not grant any stock options in 2024 or 2023 and does not intend to grant any further options under the Option Plans.

As at March 31, 2024, there were 1,151,840 stock options outstanding under the Option Plans.

Depletion & Depreciation

	Three months ended March 31,		Percent Change
	2024	2023	
	<i>(thousands of dollars)</i>		
Depletion	30,467	28,441	7
Depreciation	61	216	(72)
Depletion & depreciation	<u>30,528</u>	<u>28,657</u>	7
Depletion – Per boe (\$)	17.21	18.63	(8)
Depreciation – Per boe (\$)	0.03	0.14	(79)
Depletion & depreciation per boe (\$)	17.24	18.77	(8)

Depletion expense is calculated using the unit-of-production method which is based on production volumes in relation to the proved plus probable reserves base.

Depletion expense for the three months ended March 31, 2024, increased slightly to \$30.5 million from \$28.4 million in the corresponding period of 2023, due to an increase in the Company’s production volumes over the period.

Depletion and depreciation expense per boe decreased during the three months ended March 31, 2024, when compared to the corresponding period of 2023, primarily due to significant reserve additions recorded in Headwater’s 2023 year-end reserves report, resulting from successful drilling and waterflood results.

Impairment Assessment

As at March 31, 2024, there were no indicators of impairment identified for the Company’s E&E (as defined herein) or property, plant and equipment (“PP&E”) assets. As such, an impairment test was not performed.

Current and Deferred Income Taxes

	Three months ended March 31,		Percent Change
	2024	2023	
	(thousands of dollars)		
Current income tax expense	12,233	8,572	43
Deferred income tax (recovery) expense	(670)	615	(209)
Total income tax expense	11,563	9,187	26
Current income tax expense – Per boe (\$)	6.91	5.61	23
Deferred income tax (recovery) expense – Per boe (\$)	(0.38)	0.40	(195)
Total income tax expense – Per boe (\$)	6.53	6.01	9

For the three months ended March 31, 2024, the Company recorded current income taxes of \$12.2 million and a deferred income tax recovery of \$0.7 million. Current income taxes increased by 43% from the prior year as a result of lower available tax pool claims, coupled with higher adjusted funds flow from operations for the three months ended March 31, 2024, compared to the corresponding period of the prior year.

Cash Flows Provided by Operating Activities and Adjusted Funds Flow from Operations

Refer to the heading “Non-GAAP and Other Financial Measures” for more information.

	Three months ended March 31,		Percent Change
	2024	2023	
	(thousands of dollars)		
Cash flows provided by operating activities	55,047	60,201	(9)
Changes in non-cash working capital	4,628	(8,414)	(155)
Current income taxes	(12,233)	(8,572)	43
Income taxes paid	29,004	15,942	82
Adjusted funds flow from operations ⁽¹⁾	76,446	59,157	29

	Three months ended March 31,		Percent Change
	2024	2023	
	(\$/boe)		
Cash flows provided by operating activities	31.09	39.42	(21)
Changes in non-cash working capital	2.61	(5.51)	(147)
Current income taxes	(6.91)	(5.61)	23
Income taxes paid	16.38	10.45	57
Adjusted funds flow netback ⁽²⁾	43.17	38.75	11

(1) Capital management measure. Refer to “Management of capital” in note 12 of the interim financial statements and to “Non-GAAP and Other Financial Measures” within this MD&A.

(2) Non-GAAP ratio. Refer to the advisory “Non-GAAP and Other Financial Measures”.

For the three months ended March 31, 2024, adjusted funds flow from operations increased to \$76.4 million from \$59.2 million in the corresponding period of the prior year as a result of a 16% increase in realized commodity pricing coupled with a 15% increase in sales volumes partially offset by higher overall cash costs including royalties, transportation, production expense and current income taxes.

Capital Expenditures

	Three months ended March 31,		Percent Change
	2024	2023	
	<i>(thousands of dollars)</i>		
Land acquisition, retention and geological and geophysical	11,729	4,498	161
Site preparation	5,875	5,363	10
Drilling and completions	37,152	51,971	(29)
Equipping and facilities	10,511	7,662	37
Capital expenditures ⁽¹⁾	65,267	69,494	(6)

(1) Non-GAAP financial measure. Refer to “Non-GAAP and Other Financial Measures” within this MD&A.

During the three months ended March 31, 2024, the Company invested a total of \$65.3 million on capital expenditures including \$37.2 million on drilling and completions, \$11.7 million on land acquisition and geological and geophysical costs, \$10.5 million on equipping and facilities and \$5.9 million on site preparation including road construction.

Land expenditures of \$11.7 million contributed an additional 81.4 net sections to Headwater’s land base in and outside of the Clearwater area.

Drilling Activity

The following table summarizes the Company’s drilling results:

	Three months ended March 31,			
	2024		2023	
	Gross	Net	Gross	Net
Heavy crude oil	20	20.0	24	24.0
Natural gas	-	-	-	-
Injection	3	3.0	2	2.0
Source/stratigraphic test	3	3.0	2	2.0
Junked and abandoned	-	-	-	-
Total	26	26.0	28	28.0
Success	100%	100%	100%	100%

Decommissioning Liabilities

As at March 31, 2024, the decommissioning liability of the Company was \$42.9 million. The Company recorded an increase of \$1.9 million in the obligation from the decommissioning liability of \$41.0 million as at December 31, 2023. This increase of \$1.9 million is due to additions of \$2.7 million and accretion expense of \$0.3 million partially offset by a downward change in estimate of \$1.0 million and settlements of \$0.1 million. The change in estimate is a result of an increase to the risk-free rate from 3.0% at December 31, 2023 to 3.3% at March 31, 2024, partially offset by an increase to the inflation rate from 1.6% at December 31, 2023 to 1.8% at March 31, 2024. The total undiscounted uninflated amount of estimated cash flows required to settle these obligations is \$64.7 million (December 31, 2023 - \$60.7 million).

2024 Guidance

Headwater has updated its 2024 annual adjusted funds flow from operations ⁽²⁾ guidance to \$319 million, resulting in 2024 annual exit adjusted working capital ⁽²⁾ guidance of \$86 million. Capital and annual production guidance remain unchanged.

	2024 Guidance March 7, 2024	2024 Guidance May 9, 2024
Average Daily Production Annual (boe/d)	20,000	20,000
Pricing		
Crude oil - WTI (US\$/bbl)	75.30	76.25
Crude oil - WCS (Cdn\$/bbl)	79.70	83.88
Exchange rate (US\$/Cdn\$)	0.74	0.73
Financial Summary (\$millions)		
Estimated capital expenditures ⁽¹⁾	200	200
Estimated adjusted funds flow from operations ⁽²⁾	298	319
Dividends ⁽³⁾	95	95
Estimated exit adjusted working capital ⁽²⁾	65	86

- (1) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.
- (2) Capital management measure. Refer to "Management of capital" in note 12 of the interim financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
- (3) Refer to "Dividend Policy" within this MD&A.
- (4) For assumptions utilized in respect of the above guidance, see "Forward Looking Information" within this MD&A.

Liquidity and Capital Resources

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. To aid in managing the capital structure, the Company monitors adjusted working capital and adjusted funds flow from operations, supplemented as necessary by equity and debt financings.

On November 3, 2022, Headwater announced its inaugural quarterly cash dividend of \$0.10 per common share (\$0.40 per common share annualized). The first dividend was paid on January 16, 2023, to shareholders of record at the close of business on December 30, 2022. In 2023, Headwater declared \$94.4 million related to its quarterly cash dividend.

On March 7, 2024, Headwater declared a cash dividend of \$0.10 per common share. The dividend was paid on April 15, 2024, to shareholders of record at the close of business on March 29, 2024.

As at March 31, 2024, the Company had cash of \$126.6 million, adjusted working capital of \$48.8 million and no outstanding bank debt. The Company expects to have adequate liquidity to fund its 2024 capital expenditure budget of \$200 million, quarterly cash dividends and contractual obligations in the near term through existing working capital and forecasted adjusted funds flow from operations. Headwater anticipates that it will make use of debt or equity financing for any substantial expansion of its capital program or to finance any significant acquisitions.

To the extent that the Company's existing working capital is not sufficient to pay the cash portion of the purchase price for any future acquisition, Headwater anticipates that it will make use of additional equity or debt financings as available. Alternatively, the Company may issue equity as consideration to complete any future acquisition.

Credit Facilities

The Company has a senior secured revolving syndicated credit facility with the National Bank of Canada and the Bank of Montreal ("the Lenders"). The credit facility is comprised of extendible revolving credit facilities consisting of a \$20.0 million operating facility and an \$80.0 million syndicated facility.

As at March 31, 2024, Headwater had not drawn on the credit facility. The Company does not intend to draw on its credit facility at current commodity pricing, however, Headwater may choose to draw on the facility to fund a substantial expansion of its capital program or a future acquisition.

The credit facility has a revolving period of 364 days, extendible annually at the request of the Company, subject to approval of the Lenders. If the facility is not extended on the renewal date, the amount drawn will automatically convert to a term loan and all outstanding obligations will be repayable one year after the expiry of the revolving period. The borrowing base is subject to semi-annual redeterminations occurring by May 31st and by November 30th of each year. The credit facility is secured by a demand debenture in the amount of \$250.0 million. Repayments of principal are not required until the maturity date, provided that the borrowings do not exceed the authorized borrowing base and the Company is in compliance with all covenants, representations and warranties.

The credit facility bears interest at a floating market rate with margins charged by the Lenders linked to the Company's senior debt to EBITDA ratio. EBITDA, for the purposes of calculating the senior debt to EBITDA ratio, is calculated as net income adjusted for non-cash items, interest expense and income taxes. Senior debt, for the purposes of calculating the senior debt to EBITDA ratio, is calculated as any debt of the Company excluding the financial derivative liability and repayable contribution.

The credit facility is not subject to any financial covenants. Additionally, distributions are permitted subject to compliance with a Board approved distributions policy.

Contractual Obligations and Commitments

As at March 31, 2024, the Company is committed to future payments under the following agreements:

<i>(thousands)</i>	Total	2024	2025	2026	2027	2028	Thereafter
	\$	\$	\$	\$	\$	\$	\$
Transportation and operating ⁽¹⁾	143,889	9,158	19,205	20,995	22,170	22,522	49,839
Lease ⁽²⁾	2,471	333	452	460	468	476	282
Government grant ⁽³⁾	14,168	-	1,417	4,675	8,076	-	-

(1) At March 31, 2024, Headwater has the following transportation commitments:

- a. 7- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
- b. 7- year financial commitment at \$1.9 million per year adjusted for inflation.
- c. 7- year take-or-pay transportation agreement with a current minimum volume commitment of 9,750 boe/d, increasing to 12,500 boe/d in 2026.
- d. 5-year take-or-pay transportation agreement with a current minimum volume of 191 m³/d, increasing to 318 m³/d in 2025 and increasing to 398 m³/d for the remaining 3 years.
- e. During the year ended December 31, 2023, the Company entered into an agreement to construct a natural gas gathering system with an estimated capital cost of approximately \$22.5 million. Once commissioned, which is expected to occur late 2024, the Company is entitled to be reimbursed the capital costs, in respect thereof, and will be subject to a long-term fixed take-or-pay contract. The estimated capital costs and timing of the project are preliminary and subject to change.

(2) Relates to variable operating costs, which are a non-lease component of the Company's head office lease.

(3) Relates to scheduled undiscounted re-payments of federal government funding under the terms of the repayable contribution agreement with Natural Resources Canada.

(4) Excludes leases accounted for under IFRS 16.

Common Share Information

Share Capital

(thousands)	Three months ended March 31,	
	2024	2023
Weighted average outstanding common shares ⁽¹⁾		
-Basic	235,742	234,069
-Diluted	237,552	236,279
Outstanding securities at March 31, 2024		
-Common shares		237,290
-Stock options – weighted average strike price of \$4.29		1,152
-Restricted share units		463
-Performance share units		2,744
-Deferred share units		366

- (1) The Company uses the treasury stock method to determine the dilutive effect of stock options, RSUs and PSUs. Under this method, only "in-the-money" dilutive instruments impact the calculation of diluted income per common share. This method also assumes that the proceeds received from the exercise of all "in-the-money" dilutive instruments are used to repurchase shares at the average market price.

Changes to share capital during the three months ended March 31, 2024, were the following:

- 1.3 million stock options were exercised for 0.7 million common shares on a cashless basis, and 33 thousand stock options were exercised for 33 thousand common shares for total proceeds of \$35 thousand. Contributed surplus related to the options exercised of \$1.9 million was transferred to capital stock.

Changes to share capital during the three months ended March 31, 2023, were the following:

- 1.6 million stock options were exercised for 1.1 million common shares on a cashless basis, and 0.4 million stock options were exercised for 0.4 million common shares for total proceeds of \$0.7 million. Contributed surplus related to the options exercised of \$1.6 million was transferred to capital stock.
- The remaining balance of the warrants outstanding were exercised for common shares for total proceeds of \$5 thousand. The associated fair value of the warrants of \$2 thousand, along with the proceeds received, were transferred to capital stock.

Total Market Capitalization

The Company's market capitalization at March 31, 2024 was approximately \$1.8 billion.

(thousands)	March 31, 2024
Common shares outstanding	237,290
Share price ⁽¹⁾	\$ 7.67
Total market capitalization	\$1,820,014

- (1) Represents the closing price on the TSX on March 31, 2024.

As at May 9, 2024 the Company had 237,387,223 common shares outstanding.

<i>(thousands)</i>	May 9, 2024
Outstanding securities at May 9, 2024	
-Common shares	237,387
-Stock options – weighted average strike price of \$4.29	1,010
-Restricted share units	463
-Performance share units	2,744
-Deferred share units	366

Environmental, Social and Governance (“ESG”) Update

Headwater remains committed to strong ESG performance. Recent achievements related to the Company’s ESG strategy include:

- On March 21, 2024, the Board approved a new Human Rights Policy. All Headwater employees have been provided with the policy and are required to familiarize themselves with it and abide by its principles.
- On October 25, 2023, Headwater entered into an agreement with a third party to construct a gas gathering system in Marten Hills West, which is expected to allow the Company to conserve a meaningful amount of its natural gas production in the area.
- Headwater formed an Environment, Safety and Sustainability Committee, which is comprised of independent members of the Board, to develop the Company’s approach to matters concerning the environment, health, safety and sustainability.
- Achieved its Board diversification commitment to increase women representation on the Board to 30% by the 2023 annual shareholder meeting. Devery Corbin was appointed to the Board in May 2023 at Headwater’s annual shareholder meeting. At the 2024 annual shareholder meeting, 30% of the proposed nominees for election to the Board are women.
- Headwater has received total funding of \$17.7 million from Natural Resources Canada (“NRCan”) in connection with four claim submissions to the Emissions Reduction Fund program. NRCan has provided financial assistance by way of a partially repayable interest-free loan to the Company for its working interest in the joint Marten Hills natural gas processing plant and gathering system, as well as for gas conservation equipment associated with the Company’s wholly owned oil processing facility in Marten Hills (the “Project”). Headwater will repay 80% of the financial assistance pursuant to the terms and conditions of the agreement, with the remaining 20% being non-repayable. The Project eliminates venting and flaring of methane rich natural gas from existing and future oil wells in the Company’s core area of Marten Hills. The repayable portion of the funds received are to be repaid as follows: 10% on June 30, 2025, 33% on June 30, 2026, and 57% on June 30, 2027.
- Headwater released its inaugural ESG report on November 3, 2022, highlighting key factors of the Company’s ESG program including emissions management, Indigenous and community engagement and sustainability stewardship. For more information, see the Company’s ESG report and updated 2022 Performance Tables on the Company’s website at www.headwaterexp.com.

In addition to the Environment, Safety and Sustainability Committee, the Board has also established the Audit Committee, Reserves Committee and Corporate Governance and Compensation Committee which are all comprised of independent members of the Board. The Audit Committee and the Reserves Committee ensure the integrity of the financial and reserves reporting of the Company, while the

Corporate Governance and Compensation Committee is charged with independent oversight of the director nomination process, executive compensation decisions and other corporate governance matters. For additional information relating to the governance policies and structure of the Company see the Company's management information circular dated March 25, 2024 for the annual meeting of the shareholders held on May 9, 2024, which is available on SEDAR+ at www.sedarplus.ca and the information under the heading Corporate Responsibility on the Company's website at www.headwaterexp.com.

Summary of Quarterly Information

	Q1/24	Q4/23	Q3/23	Q2/23	Q1/23	Q4/22	Q3/22	Q2/22
Financial (thousands of dollars except share data)								
Total sales	134,034	138,426	149,632	118,967	104,209	109,377	99,587	130,153
Total sales, net of blending ^{(1) (2)}	127,366	131,690	144,003	112,560	94,570	102,974	94,949	122,102
Adjusted funds flow from operations ⁽³⁾	76,446	81,983	80,887	66,235	59,157	71,828	58,441	79,435
Per share - basic ⁽⁴⁾	0.32	0.35	0.34	0.28	0.25	0.31	0.25	0.35
- diluted ⁽⁴⁾	0.32	0.34	0.34	0.28	0.25	0.31	0.25	0.34
Cash flows provided by operating activities	55,047	90,690	85,568	66,857	60,201	66,448	72,060	84,728
Net income	37,619	45,469	49,677	30,947	29,979	39,789	31,545	48,412
Per share - basic	0.16	0.19	0.21	0.13	0.13	0.17	0.14	0.21
- diluted	0.16	0.19	0.21	0.13	0.13	0.17	0.13	0.21
Capital expenditures ⁽²⁾	65,267	30,050	70,208	64,094	69,494	60,677	71,001	30,860
Depletion and depreciation	30,528	31,476	30,723	29,341	28,657	25,842	17,284	17,243
Adjusted working capital ⁽³⁾	48,841	63,526	35,921	48,968	70,467	104,918	117,967	130,206
Working capital	58,336	78,610	43,496	54,765	77,415	109,433	113,381	127,101
Shareholders' equity	625,675	610,498	587,380	559,779	551,160	543,335	525,006	492,145
Dividends declared	23,729	23,658	23,638	23,586	23,539	23,392	-	-
Per share	0.10	0.10	0.10	0.10	0.10	0.10	-	-
Weighted average shares (thousands)								
Basic	235,742	236,408	236,191	235,631	234,069	231,766	229,909	226,168
Diluted ⁽⁵⁾	237,552	238,872	239,167	237,913	236,279	235,305	236,658	233,479
Shares outstanding, end of period (thousands)								
Basic	237,290	236,580	236,384	235,864	235,386	233,920	229,911	229,908
Diluted ⁽⁶⁾	241,356	241,138	241,175	241,240	241,368	241,029	241,593	241,585
Operating (6:1 boe conversion)								
Average daily production								
Heavy oil (bbls/d)	17,512	18,514	16,902	15,624	14,777	13,536	10,842	10,637
Natural gas (mmcf/d)	11.5	8.0	6.1	8.5	12.8	11.5	4.3	6.4
Natural gas liquids (bbls/d)	87	93	103	107	91	99	55	66
Barrels of oil equivalent (boe/d) ⁽⁷⁾	19,517	19,939	18,027	17,152	17,004	15,546	11,612	11,772
Average daily sales ⁽⁸⁾								
Heavy oil (\$/bbl)	76.04	74.69	92.05	77.14	65.41	73.10	92.35	121.49
Natural gas (\$/mcf)	5.03	3.00	2.36	2.51	5.58	10.15	4.23	7.28
Natural gas liquids (\$/bbl)	70.69	73.53	86.65	75.01	66.53	73.02	95.54	113.61
Barrels of oil equivalent (\$/boe)	71.49	70.94	87.56	71.98	61.40	71.60	88.27	114.34
Netbacks (\$/boe)								
Operating								
Sales, net of blending ^{(1) (2)}	71.93	71.09	87.63	72.11	61.93	71.90	88.36	114.63
Realized gain (loss) on financial derivatives	3.45	3.35	0.18	0.21	4.74	2.96	-	(0.24)
Royalties	(12.34)	(12.91)	(16.26)	(12.63)	(10.04)	(13.51)	(21.93)	(23.85)
Transportation	(5.35)	(5.12)	(5.32)	(5.48)	(5.50)	(4.21)	(3.94)	(4.07)
Production	(7.04)	(7.34)	(7.43)	(7.33)	(6.53)	(6.25)	(5.95)	(5.66)
Operating netback, including financial derivatives (\$/boe) ^{(4) (9)}	50.65	49.07	58.80	46.88	44.60	50.89	56.54	80.81
General and administrative	(1.47)	(1.51)	(1.52)	(1.49)	(1.35)	(1.14)	(1.46)	(1.52)
Interest income and other expense ⁽¹⁰⁾	0.95	0.84	0.85	0.96	1.11	1.15	1.18	0.44
Current income taxes	(6.91)	(4.14)	(8.91)	(3.91)	(5.61)	(0.75)	(1.87)	(5.16)
Settlement of decommissioning liability	(0.05)	-	-	-	-	-	-	-
Adjusted funds flow netback (\$/boe) ^{(4) (9)}	43.17	44.26	49.22	42.44	38.75	50.15	54.39	74.57

- (1) Heavy oil sales are netted with blending expense to compare the realized price to benchmark. In the interim financial statements, blending is recorded in blending and transportation expense.
- (2) Non-GAAP financial measure. Refer to “Non-GAAP and Other Financial Measures” within this MD&A.
- (3) Capital management measure. Refer to “Management of capital” in note 12 of the interim financial statements and to “Non-GAAP and Other Financial Measures” within this MD&A.
- (4) Non-GAAP ratio. Refer to the advisory “Non-GAAP and Other Financial Measures”.
- (5) Diluted weighted average shares outstanding includes the impact of any stock options, RSUs and PSUs that would be outstanding as dilutive instruments using the treasury stock method. The number of outstanding RSUs and PSUs have been adjusted for dividends.
- (6) Includes in-the-money dilutive instruments as at March 31, 2024 which include 1.2 million stock options with a weighted average exercise price of \$4.29 and 2.9 million PSUs. The number of outstanding PSUs has been adjusted for dividends. RSUs have been excluded as the Company intends to cash settle these awards.
- (7) See barrels of oil equivalent under “Oil and Gas Measures”.
- (8) Includes sales of unblended heavy crude oil. The Company’s heavy oil sales volumes and production volumes differ due to changes in inventory.
- (9) Netbacks are calculated using average sales volumes.
- (10) Excludes unrealized foreign exchange gains/losses, accretion on decommissioning liabilities, interest on repayable contribution and interest on the lease liability.

Headwater has experienced significant quarterly growth over the past two years as a result of its significant capital expenditure programs. The Company has grown production from 11,772 boe/d in the second quarter of 2022 to 19,517 boe/d in the first quarter of 2024, while maintaining a significant positive working capital balance and distributing a quarterly dividend since announcing its dividend policy in the fourth quarter of 2022. This production growth is attributed to successful drilling results in the Company’s Marten Hills core and west areas, as well as newer areas within Greater Peavine and Greater Nipisi. Headwater’s realized heavy oil pricing increased in the first quarter of 2024 as a result of improved WCS pricing and blending optimization. Higher pricing, partially offset by higher overall cash costs and current income taxes contributed to adjusted funds flow from operations of \$76.4 million, funding capital expenditures of \$65.3 million, in the first quarter of 2024.

Off-Balance Sheet Arrangements

All off-balance sheet arrangements are in the normal course of business. Refer to the commitments under the heading “Contractual Obligations and Commitments”.

Subsequent Events

Dividend

Subsequent to March 31, 2024, the Company declared a cash dividend of \$0.10 per common share. The dividend will be paid on July 15, 2024, to shareholders of record at the close of business on June 28, 2024.

Financial Derivative Contract

Subsequent to March 31, 2024, Headwater entered into the following commodity contract:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT	Fixed	Dec 2024 - Jan 2025	2,500 mmbtu	Cdn\$13.75/mmbtu

Non-GAAP and Other Financial Measures

Throughout this MD&A, the Company uses various non-GAAP and other financial measures to analyze operating performance and financial position. These non-GAAP and other financial measures do not have standardized meanings prescribed under IFRS and therefore may not be comparable to similar measures presented by other entities.

Non-GAAP Financial Measures

Heavy oil sales, net of blending

Management utilizes heavy oil sales, net of blending expense to compare realized pricing to WCS benchmark pricing. It is calculated by deducting the Company's blending expense from heavy oil sales. In the interim financial statements blending expense is recorded within blending and transportation expense.

	Three months ended March 31,	
	2024	2023
	(thousands of dollars)	
Heavy oil sales	127,446	96,422
Blending expense	(6,668)	(9,639)
Heavy oil sales, net of blending expense	120,778	86,783

Total sales, net of blending

Management utilizes total sales, net of blending expense to compare realized pricing to benchmark pricing. It is calculated by deducting the Company's blending expense from total sales. In the interim financial statements blending expense is recorded within blending and transportation expense.

	Three months ended March 31,	
	2024	2023
	(thousands of dollars)	
Total sales	134,034	104,209
Blending expense	(6,668)	(9,639)
Total sales, net of blending expense	127,366	94,570

Capital expenditures

Management utilizes capital expenditures to measure total cash capital expenditures incurred in the period. Capital expenditures represents capital expenditures – E&E and capital expenditures – PP&E in the statement of cash flows in the Company's interim financial statements.

	Three months ended March 31,	
	2024	2023
	(thousands of dollars)	
Cash flows used in investing activities	51,580	57,957
Proceeds from government grant	177	-
Change in non-cash working capital	13,510	11,537
Capital expenditures	65,267	69,494

Capital Management Measures

Adjusted funds flow from operations

Management considers adjusted funds flow from operations to be a key measure to assess the Company's management of capital. Adjusted funds flow from operations is an indicator as to whether adjustments are necessary to the level of capital expenditures. For example, in periods where adjusted funds flow from operations is negatively impacted by reduced commodity pricing, capital expenditures may need to be reduced or curtailed to preserve the Company's capital and dividend policy. Management believes that by excluding the impact of changes in non-cash working capital and adjusting for current income taxes in the period, adjusted funds flow from operations provides a useful measure of Headwater's ability to generate the funds necessary to manage the capital needs of the Company.

	Three months ended March 31,	
	2024	2023
	<i>(thousands of dollars)</i>	
Cash flows provided by operating activities	55,047	60,201
Changes in non-cash working capital	4,628	(8,414)
Current income taxes	(12,233)	(8,572)
Current income taxes paid	29,004	15,942
Adjusted funds flow from operations	76,446	59,157

Adjusted working capital

Adjusted working capital is a capital management measure which management uses to assess the Company's liquidity. Financial derivative receivable/liability have been excluded as these contracts are subject to a high degree of volatility prior to settlement and relate to future production periods. Financial derivative receivable/liability are included in adjusted funds flow from operations when the contracts are ultimately realized. Management has included the effects of the repayable contribution to provide a better indication of Headwater's net financing obligations.

	March 31, 2024	December 31, 2023
	<i>(thousands of dollars)</i>	
Working capital	58,336	78,610
Repayable contribution	(11,619)	(11,405)
Financial derivative receivable	(205)	(3,758)
Financial derivative liability	2,329	79
Adjusted working capital	48,841	63,526

Non-GAAP Ratios

Adjusted funds flow netback, operating netback and operating netback, including financial derivatives

Adjusted funds flow netback, operating netback and operating netback, including financial derivatives are non-GAAP ratios and are used by management to better analyze the Company's performance against prior periods on a more comparable basis.

Adjusted funds flow netback is defined as adjusted funds flow from operations divided by sales volumes in the period.

Operating netback is defined as sales less royalties, transportation and blending costs and production expense divided by sales volumes in the period. Sales volumes exclude the impact of purchased condensate and butane. Operating netback, including financial derivatives is defined as operating netback plus realized gains on financial derivatives.

Adjusted funds flow per share

Adjusted funds flow per share is a non-GAAP ratio used by management to better analyze the Company's performance against prior periods on a more comparable basis. Adjusted funds flow per share is calculated as adjusted funds flow from operations divided by weighted average shares outstanding during the applicable period on a basic or diluted basis.

Royalty rate or percentage of total sales, net of blending

Corporate royalty rate or percentage of total sales, net of blending are non-GAAP ratios used by management to better analyze the Company's performance against prior periods on a more comparable basis and are calculated as total royalties divided by total sales, net of blending expense, expressed as a percentage.

Supplementary Financial Measures

Per boe numbers

This MD&A represents various results on a per boe basis including financial derivatives gains (losses) per boe, royalty expense per boe, transportation expense per boe, transportation and blending expense per boe, production expense per boe, sales expense per boe, realized gain (loss) on financial derivatives per boe, general and administrative expenses per boe, interest income and other expense per boe, stock-based compensation expense per boe, depletion expense per boe, depreciation expense per boe, depletion and depreciation expense per boe, current income tax expense per boe, deferred income tax expense per boe, total income tax expense per boe, cash flows provided by operating activities per boe, changes in non-cash working capital per boe and settlement of decommissioning liabilities per boe. These figures are calculated using sales volumes.

Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, disclosure controls and procedures as defined in National Instrument 52-109 of the Canadian Securities Administrators, to provide reasonable assurance that (i) material information relating to the Company is made known to the Chief Executive Officer and Chief Financial Officer by others, particularly during the period in which the annual and interim filings are being prepared and (ii) information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation.

Internal Controls over Financial Reporting

The Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, internal controls over financial reporting as defined in National Instrument 52-109 of the Canadian Securities Administrators, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company confirms that there were no changes to Headwater's internal controls over financial reporting during the interim period from January 1, 2024 to March 31, 2024 that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

It should be noted that while Headwater's Chief Executive Officer and Chief Financial Officer believe that the Company's internal controls and procedures provide a reasonable level of assurance and that they are effective, they do not expect that these controls will prevent all errors or fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

Critical Accounting Estimates

Use of estimates and judgments

The preparation of the Company's financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions are evaluated at each reporting date and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Estimates are more difficult to determine, and the range of potential outcomes can be wider, in periods of higher volatility and uncertainty. The impacts of various events such as the Russian invasion of Ukraine and the war between Israel and Hamas and its impact on energy markets and general market conditions, increased interest and inflation rates and supply chain uncertainties have created a higher level of volatility and uncertainty. Management has, to the extent reasonable, incorporated known facts and circumstances into the estimates made however, actual results could differ from those estimates and those differences could be material. The Company has identified the following areas requiring significant judgments, assumptions or estimates.

Climate change

The following provides certain disclosures as to the impact of climate change on the amounts recorded in the financial statements as at and for the three months ended March 31, 2024. The below is not a comprehensive list or analysis of all climate change impacts and risks.

Emissions, carbon and other regulations impacting climate and climate related matters are constantly evolving. With respect to climate reporting, the International Sustainability Standards Board ("ISSB") has issued two international disclosure standards, with the aim to develop sustainability and climate disclosure standards that are globally consistent, comparable and reliable. In addition, the Canadian Securities Administrators have issued a proposed National Instrument 51-107 - Disclosure of Climate-Related Matters, finalization and implementation of which have been paused pending further public consultation on the applicability of the international standards in Canada. The cost to comply with standards such as these, when they are approved by Canadian regulators, and others that may be developed or evolve over time, has not yet been quantified.

The Company has considered the impact of the evolving worldwide demand for energy and global advancement of alternative sources of energy that are not sourced from fossil fuels in its assessment as a possible indication of impairment of its oil and gas properties. The Company completed the analysis of triggers for impairment as at March 31, 2024 and climate risk/climate change, in of itself, did not result in the Company completing an impairment test. The Company has considered the impact of the evolving worldwide demand for energy and global advancement of alternative sources of energy that are not sourced from fossil fuels in its assessment of depletion on its oil and gas properties. Depletion of the Company's oil and gas properties was based on proved and probable reserves, the life of which is generally less than 25 years. The ultimate period in which global energy markets can transition from carbon-based sources to alternative energy is highly uncertain, however, the majority of the Company's proved and probable reserves per the 2023 reserve report should be realized prior to the elimination of carbon-based energy. At this time, the Company has not capped its reserve life for purposes of calculating depletion expense, however, this estimate will be monitored as the energy evolution continues.

The Company engages a third-party external reserve engineer to prepare the reserve report. The reserve report includes anticipated impacts from emissions related taxes, most notably the reserve report includes estimated carbon tax related to the Company's operations consistent with the Emissions Management and Climate Resilience Act (Alberta).

The evolving energy transition and general public sentiment to the oil and gas industry may result in reduced access to capital markets. Management will continue to adjust the capital structure as necessary in response to changing industry conditions.

The Company's financial results for three months ended March 31, 2024 were not materially impacted from a climate event. In the three months ended March 31, 2024, the Company did not incur material weather related damages to its PP&E. During the three months ended March 31, 2024, management is not aware of a material disruption in its supply chain or to the marketers of the Company's product related to climate events.

The Company maintains insurance coverage that provides a level of insurance for certain events that may arise due to climate change factors; however, the Company's insurance program is subject to limits and various restrictions. No claims were made under the Company's insurance policies in the three months ended March 31, 2024 with respect to climate related matters.

Critical Judgments in Applying Accounting Policies

Determination of cash-generating units ("CGU") and impairment

The determination of what constitutes a CGU used to test the recoverability of the carrying values of the Company's oil and gas properties is subject to management's judgment. Judgments are made in regard to shared infrastructure, geographical proximity, petroleum type and similar exposure to market risks and materiality. The asset composition of a CGU can directly impact the recoverability of the assets included therein.

Judgments are required to assess when impairment or impairment reversal indicators exist and impairment testing is required.

Exploration and evaluation ("E&E") assets

The application of the Company's accounting policy for E&E assets requires management to make certain judgments as to whether economic quantities of reserves have been found. Judgment is also required to determine the level at which E&E is assessed for impairment; for Headwater, the recoverable amount of E&E assets is assessed at a CGU level.

Key Sources of Estimation Uncertainty

Recoverability of asset carrying value and the impact of reserves on depletion and the evaluation of the recoverable amount of a CGU

At each reporting date, the Company assesses its PP&E and E&E assets to determine if there is any indication that the carrying amount of the assets may not be recoverable. An assessment is also made at each reporting date to determine whether there is any indication that previously recognized impairment losses no longer exist or have decreased. Determination as to whether and how much an asset is impaired, or no longer impaired, involves management's estimates on highly uncertain matters. The key estimates used in the determination of cash flows from crude oil and natural gas reserves and the volume of proved and probable crude oil and natural gas reserves include the following:

- Reserves and forecasted production – assumptions that are valid at the time of reserve estimation may change significantly when new information becomes available. Changes in future price estimates, production levels or results of future drilling may change the economic status of reserves and may ultimately result in reserve revisions.

- Forecasted crude oil and natural gas prices – commodity prices can fluctuate for a variety of reasons including supply and demand fundamentals, inventory levels, exchange rates, weather, and economic and geopolitical factors.
- Discount rate – the discount rate used to calculate the net present value of cash flows is based on estimates of an approximate industry peer group weighted average cost of capital. Changes in the general economic environment could result in significant changes to this estimate.
- Forecasted operating and royalty costs and future development costs – estimates concerning future drilling and infrastructure costs and production costs required to operate the assets are used in the cash flow model.

Changes in circumstances may impact these estimates which could have a material financial impact in future periods.

Reserves estimates also have a material financial impact on depletion expense and decommissioning liabilities, all of which could have a material impact on financial results. These reserve estimates are evaluated by third-party reserve evaluators at least annually, who work with information provided by the Company to establish reserve determinations in accordance with National Instrument 51-101 - Standards of Disclosure for Oil and Gas Activities ("NI 51-101"). Changes in circumstances may impact these estimates which could have a material financial impact in future periods.

Decommissioning liabilities

The decommissioning costs which will ultimately be incurred by the Company are uncertain and estimates can vary in response to many factors including changes to relevant legal requirements, the emergence of new restoration techniques or experience at other production sites. The expected timing can also change in response to changes in reserves or changes in laws and regulations. As a result, there could be significant adjustments to the provisions established which could materially affect future financial results. Judgments include the most appropriate discount rate to use, which management has determined to be a risk-free rate.

Valuation of financial instruments

The estimated fair values of the Company's financial derivative commodity contracts are subject to measurement uncertainty due to the estimation of future crude oil and natural gas commodity prices and volatility.

Valuation of performance share units ("PSUs")

The estimate of stock-based compensation in respect of the Company's PSUs is dependent on the performance multiplier estimated by management.

New accounting pronouncements

The IASB issued amendments to IAS 1 "Presentation of financial statements" re: classification of liabilities as current or non-current which is effective for annual periods beginning on or after January 1, 2024. The amendment clarifies that the classification of liabilities as current or non-current should be based on rights that are in existence at the end of the reporting period.

These amendments to IAS 1 did not have a material impact on the Company's financial statements.

Changing regulation

On June 26, 2023, the International Sustainability Standards Board (“ISSB”) issued IFRS S1 - General Requirements for Disclosure of Sustainability-Related Financial Information (“IFRS S1”), and IFRS S2 – Climate Related Disclosures (“IFRS S2”).

On March 13, 2024, the Canadian Sustainability Standards Board (“CSSB”) released exposure drafts for two proposed standards; Canadian Sustainability Disclosure Standard 1 (“CSDS S1”) – General Requirements for Disclosure of Sustainability-related Financial Information and Canadian Sustainability Disclosure Standard 2 (“CSDS S2”) – Climate-related Disclosures. The CSSB has provided a consultation period for comment on the proposed standards until June 10, 2024. The CSSB proposes that CSDS S1 and CSDS S2 should be effective for annual reporting periods beginning on or after January 1, 2025. The sustainability standards as proposed by the CSSB provide for transition relief that allow a reporting entity to report on climate only risks and opportunities and exclude scope 3 in the first and second year of reporting and allow for a reporting timeline extension in the first year of reporting under the sustainability standards. The CSSB aims to release final versions of CSDS S1 and CSDS S2 in Q4 of 2024, following which the Canadian Securities Administrators will begin their own consultation process to determine how the reporting standards will be translated into reporting requirements for reporting issuers.

The Company is committed to transparent and comprehensive reporting of its sustainability performance and is actively evaluating the potential effects of the CSSB issued draft sustainability standards; however, at this time, the Company is not able to determine the impact on future financial statements, nor the potential costs to comply with these sustainability standards.

Business Conditions and Risks

There are numerous factors both known and unknown, that could cause actual results or events to differ materially from forecast results. The following is a summary of such risk factors, which should not be construed as exhaustive:

- Volatility in the market conditions for the oil and natural gas industry may affect the value of the Company's reserves and restrict its cash flow and ability to access capital to fund the development of its properties;
- Various factors may adversely impact the marketability of oil and natural gas, affecting net production revenue, production volumes and development and exploration activities;
- The anticipated benefits of acquisitions may not be achieved and the Company may dispose of non-core assets for less than their carrying value on the financial statements as a result of weak market conditions;
- The impact of the Russian Ukrainian conflict and the Israel-Palestine war on commodity prices and the world economy could affect the Company's results, business, financial conditions or liquidity;
- Natural disasters (including the risk of wildfires in the areas in which the Company operates), terrorist acts, civil unrest, war, pandemics and other disruptions and dislocations may affect the Company's results, business, financial conditions or liquidity;
- The Company's business may be adversely affected by political and social events and decisions made in Canada, the United States, Europe and elsewhere;
- Lack of capacity and/or regulatory constraints on gathering and processing facilities and pipeline systems may have a negative impact on the Company's ability to produce and sell its oil and natural gas;
- The Company competes with other oil and natural gas companies, some of which have greater financial and operational resources;

- The Company's ability to successfully implement new technologies into its operations in a timely and efficient manner will affect its ability to compete;
- Changes to the demand for oil and natural gas products and the rise of petroleum alternatives may negatively affect the Company's financial condition, results of operations and cash flow;
- Modification to current, or implementation of additional, regulations (including environmental regimes) or royalty regimes may reduce the demand for oil and natural gas, impact the Company's cash flows and/or increase the Company's costs and/or delay planned operations;
- Taxes on carbon emissions affect the demand for oil and natural gas, the Company's operating expenses and may impair the Company's ability to compete;
- Liability management programs enacted by regulators in the western provinces may prevent or interfere with the Company's ability to acquire properties or require a substantial cash deposit with the regulator;
- The Company may require additional financing, from time to time, to fund the acquisition, exploration and development of properties and its ability to obtain such financing in a timely fashion and on acceptable terms may be negatively impacted by the current economic and global market volatility;
- Changing investor sentiment towards the oil and natural gas industry may impact the Company's access to, and cost of, capital;
- Oil and natural gas operations are subject to seasonal weather conditions and, if applicable to the Company's operations in the future, the Company may experience significant operational delays as a result;
- Regulatory water use restrictions and/or limited access to water or other fluids may impact the Company's future production volumes from any future waterflood of the Company;
- Credit risk related to non-payment for sales contracts or other counterparties;
- Foreign exchange risk as commodity sales are based on U.S. dollar denominated benchmarks; and
- The risk of significant interruption or failure of the Company's information technology systems and related data and control systems or a significant breach that could adversely affect the Company's operations.

Additional risks and information on risk factors are included in the Annual Informational Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR+ at www.sedarplus.ca.

The Company uses a variety of means to help mitigate or minimize these risks including the following:

- Attracting and retaining a team of highly qualified and motivated professionals who have a vested interest in the success of the Company;
- Employing risk management instruments to minimize exposure to volatility of commodity prices;
- Maintaining a strong financial position;
- Maintaining strict environmental, safety and health practices;
- Maintaining a comprehensive insurance program;
- Managing credit risk by entering into agreements with counterparties that are highly credit worthy or investment grade; and
- Implementation of cyber security protocols and procedures to reduce to risk of failure of breach of data.

Oil and Gas Metrics

The term barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. Per boe amounts have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil. This equivalence is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. As the value ratio between natural gas and crude oil based on the current prices of natural gas and crude oil is significantly different from the energy equivalency of 6:1, utilizing a conversion on a 6:1 basis may be misleading as an indication of value.

References to heavy oil, natural gas, and natural gas liquids in the MD&A refer to heavy crude oil, conventional natural gas and natural gas liquids, respectively, product types as defined in NI 51-101.

Dividend Policy

The amount of future cash dividends paid by the Company, if any, will be subject to the discretion of the Board and may vary depending on a variety of factors and conditions existing from time to time, including, among other things, adjusted funds flow from operations, fluctuations in commodity prices, production levels, capital expenditure requirements, acquisitions, debt service requirements and debt levels, operating costs, royalty burdens, foreign exchange rates and the satisfaction of the liquidity and solvency tests imposed by applicable corporate law for the declaration and payment of dividends. Depending on these and various other factors, many of which will be beyond the control of the Company, the Board will adjust the Company's dividend policy from time to time and, as a result, future cash dividends could be reduced or suspended entirely.

Forward Looking Information

This MD&A contains certain forward-looking statements and forward-looking information (collectively referred to herein as "forward-looking statements") within the meaning of Canadian securities laws. All statements other than statements of historical fact are forward-looking statements. Forward-looking information typically contains statements with words such as "anticipate", "believe", "plan", "continuous", "estimate", "expect", "may", "will", "project", "should" or similar words suggesting future outcomes. In particular, this MD&A contains forward-looking statements pertaining to the following:

- business plans and strategies (including its production optimization and hedging strategies);
- the expectation Marten Hills West natural gas tie-in infrastructure will cost \$22.5 million and be commissioned in late 2024;
- the Company's intent to settle PSUs in equity;
- the Company's intent to settle DSUs and RSUs in cash;
- the Company's intent to not grant any further options under the Option Plans;
- the expectation that Headwater could make use of additional equity or debt financings to fund any substantial expansion of its capital program or for future acquisitions;
- the expectation that the Company has adequate liquidity to fund its 2024 capital expenditure budgets, future dividend payments and contractual obligations in the near term through existing working capital and forecasted cash flows from operations;
- the expectation that Headwater does not intend to draw on its credit facility at current commodity pricing;
- 2024 crude oil and natural gas pricing assumptions;
- 2024 Canadian – U.S. dollar exchange rates;

- 2024 budget and guidance related to annual production, capital expenditures, dividends, adjusted funds flow from operations and adjusted working capital;
- the Company's future contractual obligations and commitments;
- the expectation that the energy transition and general public sentiment to oil and gas may reduce access to capital markets and the expectation that the Company will adjust its capital structure as necessary in response to changing industry conditions;
- Headwater's commitment to strong ESG performance;
- the Company's dividend policy;
- the Company's commitment to transparent and comprehensive reporting of its sustainability performance and active evaluation of the potential effects of the CSSB issued draft sustainability standards;
- the estimated amount to settle the Company's decommissioning liabilities; and
- the expectation that the majority of the Company's proved and probable reserves per the 2023 reserve report should be realized prior to the elimination of carbon-based energy.

Statements relating to "reserves" are forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the reserves described, as applicable, exist in the quantities predicted or estimated and can profitably be produced in the future. Undue reliance should not be placed on forward-looking statements, which are inherently uncertain, are based on estimates and assumptions, and are subject to known and unknown risks and uncertainties (both general and specific) that contribute to the possibility that the future events or circumstances contemplated by the forward-looking statements will not occur. There can be no assurance that the plans, intentions or expectations upon which forward-looking statements are based, will in fact be realized. Actual results will differ, and the difference may be material and adverse to the Company and its shareholders.

The forward-looking statements contained herein are based on certain key expectations and assumptions made by the Company, including but not limited to expectations and assumptions concerning the success of optimization and efficiency improvement projects, the availability of capital, current legislation, receipt of required regulatory approval, the success of future drilling, development and waterflooding activities, the performance of existing wells, the performance of new wells, Headwater's growth strategy, general economic conditions including inflationary pressures, availability of required equipment and services, prevailing equipment and services costs and prevailing commodity prices. Although the Company believes that the expectations and assumptions on which the forward-looking statements are based are reasonable, undue reliance should not be placed on the forward-looking statements because the Company can give no assurance that they will prove to be correct.

This MD&A contains information that may be considered a financial outlook or future-oriented financial information under applicable securities laws about the Company's potential financial position, including but not limited to: the expectation that the Marten Hills West natural gas tie-in infrastructure will cost \$22.5 million; the Company's 2024 budget and guidance related to capital expenditures, dividends, adjusted funds flow from operations and adjusted working capital; the Company's future contractual obligations and commitments; and the estimated amount to settle the Company's decommissioning liabilities. Any financial outlook or future-oriented financial information in this MD&A, as defined by applicable securities legislation, has been approved by management of the Company as of the date hereof. Readers are cautioned that any such future-oriented financial information contained herein should not be used for purposes other than those for which it is disclosed herein. The Company and its management believe that the prospective financial information as to the anticipated results of its proposed business activities for the periods specified herein has been prepared on a reasonable basis, reflecting management's best estimates and judgments, and represent, to the best of management's knowledge and opinion, the Company's expected course of action. However, because this information is highly subjective, it should not be relied on as necessarily indicative of future results. The assumptions used in the 2024 guidance include: annual average production of 20,000 boe/d, WTI of US\$76.25/bbl, WCS of Cdn\$83.88/bbl, AGT US\$5.11/mmbtu, AECO of Cdn\$1.88/GJ, foreign exchange rate of Cdn\$/US\$ of 0.73, blending expense of WCS less \$2.20, royalty rate of 19.0%, operating and transportation costs of \$13.45/boe, G&A and interest income and other expense of \$1.30/boe and cash taxes of \$6.85/boe. The AGT price is the average price for the winter

producing months in the McCully field which include January to April and November to December. 2024 annual production guidance comprised of: 18,650 bbls/d of heavy oil, 50 bbls/d of natural gas liquids and 7.8 mmcf/d of natural gas.

Since forward-looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to a number of factors and risks. These include, but are not limited to, the risks identified under the heading "*Business Conditions and Risks*". Further information regarding these factors and additional factors may be found under the heading "Risk Factors" in the Annual Informational Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR+ at www.sedarplus.ca. Readers are cautioned that the foregoing list of factors that may affect future results is not exhaustive.

The forward-looking statements contained in this MD&A are made as of the date hereof and the Company does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, except as required by applicable law. The forward-looking statements contained herein are expressly qualified by this cautionary statement.

Corporate Information

Board of Directors

NEIL ROSZELL
Executive Chairman, Headwater Exploration Inc.
Calgary, Alberta

JASON JASKELA
President and CEO, Headwater Exploration Inc.
Calgary, Alberta

CHANDRA HENRY ^{(1) (2)}
CFO and Chief Compliance Officer, Longbow Capital Inc.
Calgary, Alberta

STEPHEN LARKE ^{(2) (4)}
Director, Vermillion Energy Inc. and Topaz Energy Corp.
Calgary, Alberta

PHILLIP KNOLL ^{(3) (4)}
Director, Altagas Ltd.
Calgary, Alberta

KEVIN OLSON ^{(1) (3)}
Independent Businessman
Calgary, Alberta

DAVE PEARCE ^{(2) (3)}
Deputy Chairman, Azimuth Capital Management
Calgary, Alberta

KAM SANDHAR ⁽¹⁾
Executive Vice President and CFO
Cenovus Energy Inc.
Calgary, Alberta

ELENA DUMITRASCU ⁽⁴⁾
Cofounder and Chief Technology Officer, Credivera
Calgary, Alberta

DEVERY CORBIN ⁽⁴⁾
Former Chief of Staff for the Mayor of the City of Calgary
Calgary, Alberta

- (1) Audit Committee
- (2) Corporate Governance and Compensation Committee
- (3) Reserves Committee
- (4) Environment, Safety and Sustainability Committee

Website: www.headwaterexp.com

Officers

NEIL ROSZELL, P. Eng.
Executive Chairman

JASON JASKELA, P. Eng.
President and CEO

ALI HORVATH, CPA, CA
Vice President Finance & CFO

GEORGIA LITTLE, CPA, CA
Interim Vice President Finance & CFO

TERRY DANKU, P. Eng.
Vice President Engineering

JON GRIMWOOD, P. Geo.
Vice President New Ventures

DIETER DEINES
Vice President Exploration

SCOTT RIDEOUT
Vice President Land

BRAD CHRISTMAN
Chief Operating Officer

TED BROWN (Corporate Secretary)
Burnet, Duckworth & Palmer LLP

Head Office

Suite 1400, 215 – 9th Avenue SW
Calgary, Alberta T2P 1K3
Tel: (587) 391-3680

Auditors

KPMG LLP
Calgary, Alberta

Independent Reservoir Consultants

McDaniel & Associates Consultants Ltd.