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

(thousands)	September 30 2020 $	December 31 2019 $
ASSETS		
Current assets		
Cash and cash equivalents (note 12 (a) (iv))	112,672	60,957
Restricted cash (note 13 (b))	350	680
Accounts receivable (note 12 (a) (iii))	228	3,007
Financial derivatives (note 12 (a) (i))	-	1,481
Prepaids and deposits	387	287
Total current assets	113,637	66,412
Exploration and evaluation assets (note 3)	394	3,816
Property, plant and equipment (note 4)	51,316	54,118
Deferred income tax asset	3,286	3,286
Right-of-use assets (note 5)	158	289
Restricted cash (note 13 (b))	-	350
Total assets	168,791	128,271
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 12 (a) (iv))	911	1,378
Financial derivatives (note 12 (a) (i))	131	-
Deferred share units liability (note 8 (b))	53	322
Current portion of lease liability (note 5)	6	90
Total current liabilities	1,101	1,790
Lease liability (note 5)	158	195
Decommissioning liability (note 6)	12,384	11,976
Total liabilities	13,643	13,961
Shareholders' Equity		
Capital stock (note 7 (b))	290,946	247,332
Warrants (note 7 (c))	7,680	-
Contributed surplus	11,122	11,366
Deficit	(154,600)	(144,388)
Total shareholders' equity	155,148	114,310
Total liabilities and shareholders' equity	168,791	128,271

Commitments (note 13)
Subsequent event (note 14)

See accompanying notes to the condensed interim financial statements

Approved by the board

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

(signed) "Neil Roszell"
Neil Roszell, Director

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

	Three months ended September 30		Nine months ended September 30	
	2020	2019	2020	2019
(thousands, except per share data)	$	$	$	$
REVENUE				
Sales (note 9)	-	-	2,873	7,023
Royalties	-	-	(72)	(178)
	-	-	2,801	6,845
Gains (losses) on financial derivatives (note 12 (a) (i))	(280)	(137)	2,325	2,573
Revenue and gains (losses) on financial derivatives	(280)	(137)	5,126	9,418
EXPENSES				
Production	519	600	1,700	1,954
General and administrative	607	1,106	2,132	2,289
Exploration and evaluation expense (note 3)	-	-	3,821	-
Depletion and depreciation (notes 4 & 5)	75	74	3,334	3,387
Transaction costs (note 7 (b))	-	-	4,382	-
Stock-based compensation expense (note 8)	492	79	902	234
	1,693	1,859	16,271	7,864
Interest income and other (note 10)	250	215	933	625
Income (loss) before income taxes	(1,723)	(1,781)	(10,212)	2,179
Deferred income tax expense (recovery)	-	(463)	-	811
Net income (loss) and comprehensive income (loss)	**(1,723)**	**(1,318)**	**(10,212)**	**1,368**
Net income (loss) per share (note 7 (d))				
Basic and diluted	(0.01)	(0.02)	(0.08)	0.02

See accompanying notes to the condensed interim financial statements

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

Cash flow related to the following activities:	Three months ended September 30 2020	Three months ended September 30 2019	Nine months ended September 30 2020	Nine months ended September 30 2019
(thousands)	$	$	$	$
OPERATING				
Net income (loss)	(1,723)	(1,318)	(10,212)	1,368
Items not involving cash:				
Exploration and evaluation expense	-	-	3,821	-
Depletion and depreciation	75	74	3,334	3,387
Stock-based compensation expense	492	79	902	234
Unrealized losses on financial derivatives (note 12 (a) (i))	280	137	1,612	325
Deferred income tax expense (recovery)		(463)	-	811
Accretion and finance charges (notes 5 & 6)	39	69	127	170
Decommissioning liabilities settled	-	(5)	-	(17)
Change in non-cash operating working capital (note 11)	473	1,085	2,097	2,775
Cash flows provided by (used in) operating activities	(364)	(342)	1,681	9,053
FINANCING				
Issue of common shares, net of costs (note 7 (b))	-	-	48,096	-
Purchase of common shares under normal course issuer bid	-	(103)	-	(549)
Payment of lease liability (note 5)	(38)	(40)	(111)	(113)
Proceeds from exercise of stock options (note 7 (b))	-	-	2,079	18
Cash flows provided by (used in) financing activities	(38)	(143)	50,064	(644)
INVESTING				
Capital expenditures – exploration and evaluation (note 3)	(55)	(23)	(399)	(377)
Capital expenditures – property, plant and equipment (note 4)	(6)	(46)	(130)	(81)
Restricted cash	380	-	680	-
Other	-	(44)	-	(17)
Proceeds from sale of assets	-	112	-	112
Change in non-cash investing working capital (note 11)	(36)	110	(181)	(445)
Cash flows provided by investing activities	283	109	(30)	(808)
Change in cash	(119)	(376)	51,715	7,601
Cash and cash equivalents, beginning of period	112,791	61,629	60,957	53,652
Cash and cash equivalents, end of period	112,672	61,253	112,672	61,253
Cash and cash equivalents consist of:				
Cash	98,022	44,626	98,022	44,626
Short-term investments	14,650	16,627	14,650	16,627
Cash and cash equivalents, end of period	112,672	61,253	112,672	61,253

See accompanying notes to the condensed interim financial statements

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

(thousands)	Notes	Capital stock $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' equity $
Balance at January 1, 2019		**247,855**	**-**	**11,048**	**(147,203)**	**111,700**
Purchase under normal course issuer bid		(549)	-	-	-	(549)
Transfer of contributed surplus		8	-	(8)	-	-
Issued for cash on exercise of stock options		18	-	-	-	18
Stock-based compensation		-	-	255	-	255
Net income		-	-	-	1,368	1,368
Balance at September 30, 2019		**247,332**	**-**	**11,295**	**(145,835)**	**112,792**
Balance at January 1, 2020		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Issued on Recapitalization Transaction	7 (b)	50,000	-	-	-	50,000
Allocation to warrants	7 (c)	(7,680)	7,680	-	-	-
Share issue costs	7 (b)	(1,905)	-	-	-	(1,905)
Transfer of contributed surplus	7 (b)	1,120	-	(1,120)	-	-
Issued for cash on exercise of stock options	7 (b)	2,079	-	-	-	2,079
Stock-based compensation	8 (a)	-	-	876	-	876
Net loss		-	-	-	(10,212)	(10,212)
Balance at September 30, 2020		**290,946**	**7,680**	**11,122**	**(154,600)**	**155,148**

See accompanying notes to the condensed interim financial statements

1. NATURE OF OPERATIONS

Headwater Exploration Inc. (formerly Corridor Resources 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".

On March 4, 2020, Headwater announced the completion of the Recapitalization Transaction (defined herein), pursuant to which the Company raised aggregate gross proceeds of $50 million pursuant to two equity private placements, a new management team was appointed and the board of directors of the Company was reconstituted. Details of the Recapitalization Transaction are provided in note 7 of these condensed interim financial statements.

Headwater's principle place of business is located at 1700, 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 condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), specifically in accordance with IAS 34 – *Interim Financial Reporting*. The unaudited condensed interim 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, 2019. These unaudited condensed interim financial statements have been prepared following the same accounting policies as the Company's audited financial statements for the year ended December 31, 2019 except as described below.

Certain prior period amounts have been reclassified to conform to the current presentation.

These unaudited condensed interim financial statements were approved and authorized for issue by the Company's board of directors on November 6, 2020.

Basis of measurement, functional and presentation currency

The financial statements have been prepared on a historical cost basis except derivative financial instruments and deferred share units which are measured at fair value.

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

Significant judgments and estimates

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, revenue 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, 2019 annual financial statements. With the exception of the Warrants issued pursuant to the non-brokered private placement and Recapitalization Transaction (as defined herein) (see note 7 (c)) and revaluation of the options granted under the New Option Plan (as defined herein) (see note 8 (a)), there have been no significant changes in the Company's judgments and estimates applied during the interim period ended September 30, 2020, relative to those described in the most recent annual financial statements as at and for the year ended December 31, 2019.

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 condensed interim financial statements are increasingly difficult and subject to a higher degree of measurement uncertainty during this volatile period.

New accounting policy

Government grants

Since commencement of the Canada Emergency Wage Subsidy ("CEWS") program on March 15, 2020, Headwater has claimed a monthly subsidy for its eligible employees. Government grants are recognized when there is reasonable assurance that the grant will be received, and all conditions associated with the grant are met. Claims under government grant programs related to income are deducted in reporting the related expense and are recorded in the period in which the eligible expenses were incurred.

New accounting standard

In October 2018, the IASB issued amendments to the definition of a business in IFRS 3 "Business Combinations". The amendments are intended to assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. IFRS 3 continues to adopt a market participant's perspective to determine whether an acquired set of activities and assets constitute a business. The amendments clarify the minimum requirements for a business; remove the assessment of whether market participants are capable of replacing any missing elements; add guidance to help entities assess whether an acquired process is substantive; narrow the definitions of a business and of outputs; and introduce an optional fair value concentration test. The concentration test is a simplified assessment that results in an asset acquisition if substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets. If an entity chooses not to apply the concentration test, or the test is failed, then the assessment focuses on the existence of a substantive process.

The amendments to IFRS 3 are effective for annual reporting periods beginning on or after January 1, 2020 and apply prospectively. The adoption of the amendments to IFRS 3 did not impact the condensed interim financial statements, however the guidance will be incorporated into the Company's assessment of business combinations that occur after January 1, 2020.

3. EXPLORATION AND EVALUATION ASSETS

Reconciliation of movements in exploration and evaluation assets (“E&E”):

	September 30, 2020	December 31, 2019
	$	$
Balance, beginning of period	3,816	3,451
Additions	399	391
Changes in decommissioning liabilities	-	(26)
Expensed	(3,821)	-
Balance, end of period	394	3,816

Since May 27, 2016, the McCully assets in New Brunswick have been subject to a moratorium on hydraulic fracturing. The new management team believes there is significant uncertainty regarding the ultimate realization of the value of the E&E assets as all undeveloped wells in the McCully field require hydraulic fracture stimulation to be commercially productive. The Company does not currently have any plans to pursue exploratory capital spending in the McCully Field. As such, all E&E assets related to the Company’s New Brunswick CGU were expensed.

4. PROPERTY, PLANT AND EQUIPMENT

Reconciliation of movements in property, plant and equipment (“PP&E”):

	Oil and gas properties	Production facilities	Inventory	Office and other assets	Total
Cost	$	$	$	$	$
Balance at December 31, 2018	244,325	77,730	1,531	2,695	326,281
Additions	44	206	-	44	294
Transfer from (to) current assets	-	-	(32)	-	(32)
Sale of assets	(48)	(15)	-	(55)	(118)
Changes in decommissioning liabilities	707	-	-	-	707
Balance at December 31, 2019	245,028	77,921	1,499	2,684	327,132
Additions	(12)	110	-	32	130
Changes in decommissioning liabilities	291	-	-	-	291
Balance at September 30, 2020	245,307	78,031	1,499	2,716	327,553
Accumulated depletion, depreciation and impairment					
Balance at December 31, 2018	202,921	62,626	1,012	1,989	268,548
Depletion or depreciation expense	3,367	1,134	-	110	4,611
Impairment reversal	(226)	(96)	-	-	(322)
Transfer from current assets	-	-	57	-	57
Sale of assets	-	-	-	(31)	(31)
Write-down of assets	-	-	151	-	151
Balance at December 31, 2019	206,062	63,664	1,220	2,068	273,014
Depletion or depreciation expense	2,300	841	20	62	3,223
Balance at September 30, 2020	208,362	64,505	1,240	2,130	276,237
Net book value at December 31, 2019	38,966	14,257	279	616	54,118
Net book value at September 30, 2020	36,945	13,526	259	586	51,316

The calculation of depletion includes estimated future development costs relating to the development of proved reserves of $2,643 thousand for the nine months ended September 30, 2020 (September 30, 2019 - $2,652 thousand).

Q3 2020 Impairment Assessment

At September 30, 2020, no impairment indicators were determined to exist for the Company's New Brunswick CGU. Accordingly, 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 September 30, 2020:

Cost	Office building $	Land $	Vehicles $	Total $
Balance at December 31, 2018	-	-	-	-
Leases recognized at January 1, 2019	170	174	10	354
Additions	-	-	79	79
Balance at December 31, 2019	170	174	89	433
Additions	18	-	-	18
Dispositions	-	-	(89)	(89)
Balance at September 30, 2020	188	174	-	362
Accumulated depreciation				
Balance at December 31, 2018	-	-	-	-
Depreciation expense	113	8	23	144
Balance at December 31, 2019	113	8	23	144
Depreciation expense	75	8	22	105
Dispositions	-	-	(45)	(45)
Balance at September 30, 2020	188	16	-	204
Net book value at December 31, 2019	57	166	66	289
Net book value at September 30, 2020	-	158	-	158

Lease liability

The following table reconciles the changes in the lease liability as at September 30, 2020:

	September 30, 2020	December 31, 2019
	$	$
Lease liability, beginning of period	285	-
Leases recognized at January 1, 2019	-	354
Additions	18	79
Dispositions	(38)	-
Interest expense	10	15
Payment of lease liability	(111)	(163)
Lease liability, end of period	164	285
Current portion of lease liability	6	90
Non-current portion of lease liability	158	195
Total lease liability	164	285

During the nine months ended September 30, 2020, the weighted average discount rate used was 3.8%.

6. DECOMMISSIONING LIABILITY

The change in the decommissioning liability is due to the following:

	September 30, 2020	December 31, 2019
	$	$
Balance, beginning of period	11,976	11,100
Change in estimate *(1)*	241	681
Additions	50	-
Liabilities settled	-	(24)
Accretion	117	219
Balance, end of period	12,384	11,976

(1) Relates to an increase in cost estimates of $190 thousand with remainder of change due to a decrease in both the risk-free rate and inflation rate for the nine months ended September 30, 2020.

The Company's decommissioning liabilities are based on the Company's net ownership in wells, its gas processing plant and related infrastructure.

The Company has estimated the net present value of its total decommissioning liabilities to be $12,384 thousand as at September 30, 2020 (December 31, 2019 - $11,976 thousand). The total future undiscounted inflated amount of estimated cash flows required to settle these obligations is $14,999 thousand (December 31, 2019 - $16,998 thousand). The total undiscounted uninflated amount of estimated cash flows required to settle these obligations is $11,700 thousand (December 31, 2019 - $11,460 thousand). Management estimates the settlement of these obligations to occur between the years 2020 and 2040. As at September 30, 2020, a risk-free rate of 1.0% (December 31, 2019 – 1.8%) and an inflation rate of 1.3% (December 31, 2019 – 2.0%) were used to calculate the estimated fair value of the decommissioning liability.

7. CAPITAL STOCK

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

b) Issued and outstanding

	September 30, 2020		December 31, 2019	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of period	88,147	247,332	88,899	247,855
Recapitalization Transaction:				
Common shares issued	54,347	50,000	-	-
Allocation to warrants	-	(7,680)	-	-
Share issue costs	-	(1,905)	-	-
Exercise of stock options (note 8 (a))	2,550	3,199	25	26
Cancellations under normal course issuer bid	-	-	(777)	(549)
Balance, end of period	145,044	290,946	88,147	247,332

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. The Warrants vest and become exercisable as to one-third upon the 20-day volume weighted average price of the common shares equaling or exceeding $1.30, $1.60 and $1.90, respectively. 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.

- 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.

Stock Options

During the nine months ended September 30, 2020, 2,550 thousand stock options were exercised for cash proceeds of $2,079 thousand. Contributed surplus related to the options exercised of $1,120 thousand was transferred to capital stock.

During the nine months ended September 30, 2019, 25 thousand stock options were exercised for cash proceeds of $18 thousand. Contributed surplus related to the options exercised of $8 thousand was transferred to capital stock.

Normal Course Issuer Bid ("NCIB")

On August 23, 2018, the Company implemented a NCIB pursuant to the rules of the TSX that allowed the Company to purchase, for cancellation, up to 6,803,118 common shares. The NCIB expired on August 22, 2019.

During the year ended December 31, 2019, the Company purchased and cancelled 777 thousand common shares for total consideration of $549 thousand. The total cost paid, including commissions and fees, was recognized directly as a reduction in shareholders' equity. Under the NCIB, all common shares purchased were cancelled.

c) Warrants

	September 30, 2020		December 31, 2019	
	Number of Warrants	Amount	Number of Warrants	Amount
		$		$
Balance, beginning of period	-	-	-	-
Recapitalization Transaction:				
Warrants issued	21,739	7,680	-	-
Balance, end of period	21,739	7,680	-	-

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 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.

During the three months ended September 30, 2020, 7.2 million Warrants vested and became exercisable as the 20-day volume weighted average price of the Company's commons shares exceeded $1.30 (note 7(b)). There were no exercises related to the vested Warrants during the three months ended September 30, 2020.

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 the basic and diluted average common shares outstanding are in-the-money warrants and in-the-money stock options.

	Three months ended		Nine months ended	
	September 30, 2020	September 30, 2019	September 30, 2020	September 30, 2019
Weighted average shares outstanding				
Basic	145,044	88,172	131,997	88,602
Diluted	145,044	88,172	131,997	88,861

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

8. STOCK-BASED COMPENSATION

a) Stock options

The Company has a stock option plan ("Existing 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 Existing 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 Existing Option Plan generally vest 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 Existing 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 outstanding options under the Existing 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 will vest as to one third of the number of options granted on each of the first, second and third anniversaries of the date of grant, respectively, and expire four years from the date of grant.

The New Option Plan was approved by the Company’s shareholders at the Company’s annual and special meeting of shareholders held on June 15, 2020. In accordance with IFRS 2, stock options previously granted under the New Option Plan were revalued on June 15, 2020.

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

	Nine months ended September 30, 2020		Year ended December 31, 2019	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	3,490	$ 0.79	3,471	$ 0.79
Granted	6,265	$ 1.06	225	$ 0.70
Forfeited, cancelled or expired	(868)	$ 0.79	(181)	$ 0.71
Exercised (1)	(2,550)	$ 0.82	(25)	$ 0.72
Options outstanding, end of period	6,337	$ 1.04	3,490	$ 0.79
Options exercisable, end of period	66	$ 0.68	2,466	$ 0.82

(1) The Company’s weighted average share price, at the date of exercise, for stock options exercised during the nine months ended September 30, 2020 was $1.25 per common share (year ended December 31, 2019 - $0.76 per common share).

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

	Nine months ended September 30, 2020	Year ended December 31, 2019
Weighted average fair value of options granted	$ 0.55	$ 0.37
Risk-free interest rate	0.4%	1.6%
Expected forfeiture rate	9.6%	6.7%
Expected life (years)	3.9	4.5
Expected volatility (1)	61%	66%

(1) In the nine months ended September 30, 2020, the expected volatility was estimated based on a peer group historical volatility.

The range of exercise prices of stock options outstanding and exercisable as at September 30, 2020 is as follows:

	Outstanding options			Exercisable options	
Exercise prices	Number of options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$ 0.68 - $ 0.99	272	2.9	$ 0.71	66	$0.68
$ 1.00 - $ 1.13	6,065	3.5	$ 1.06	-	-
Total	6,337	3.5	$ 1.04	66	$0.68

For the nine months ended September 30, 2020, the Company recorded stock-based compensation expense of $876 thousand with a corresponding increase to contributed surplus with respect to stock options (nine months ended September 30, 2019 - $255 thousand stock-based compensation expense 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:

	Nine months ended September 30, 2020		Year ended December 31, 2019	
	Number of DSUs	Amount	Number of DSUs	Amount
		$		$
DSUs, beginning of period	447	322	388	311
DSUs redeemed during the period(1)	(409)	(535)	-	-
DSUs granted during the period	-	-	59	40
Fair value adjustment	-	266	-	(29)
DSUs, end of period	38	53	447	322

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

The DSU liability as at September 30, 2020 of $53 thousand is based on a fair value of $1.40 per DSU which is the Company's closing share price on September 30, 2020 (December 31, 2019 - $0.72 per DSU).

9. SALES

Headwater sells all of its natural gas production daily from the McCully Field in New Brunswick pursuant to a long-term agreement with Repsol Oil & Gas Canada Inc. ("Repsol"). The sales price is based on the daily commodity price adjusted for the delivery location and other seasonal factors based on the terms of the agreement. The fees associated with marketing and transportation services provided by Repsol are deducted from the sales price while transportation services procured by Headwater are recognized in transportation expenses. Headwater's natural gas revenues do not contain significant financing components and payments are typically due within 25 days following the month-end.

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

	Three months ended September 30,		Nine months ended September 30,	
	2020	2019	2020	2019
	$	$	$	$
Natural gas sales	-	-	2,500	6,574
Gathering, processing and transportation revenue	-	-	336	355
Natural gas liquids sales	-	-	37	94
	-	-	2,873	7,023

The Company may elect to shut-in production of its New Brunswick CGU assets during periods of lower pricing in order to maximize cash flows over the life of the assets in accordance with its production optimization strategy. Headwater shut-in production on both May 1, 2020 and May 1, 2019 in accordance with this strategy.

10. INTEREST INCOME AND OTHER

Interest income and other consist of the following:

	Three months ended September 30,		Nine months ended September 30,	
	2020	2019	2020	2019
	$	$	$	$
Interest income	288	279	908	850
Foreign exchange gains (losses)	(1)	(2)	153	(43)
Accretion	(29)	(53)	(117)	(169)
Interest expense	(8)	(9)	(11)	(13)
	250	215	933	625

11. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended September 30,		Nine months ended September 30,	
	2020	2019	2020	2019
	$	$	$	$
Change in non-cash operating working capital:				
Accounts receivable	287	704	2,779	3,600
Prepaids and security deposits	193	290	(100)	(109)
Accounts payable and accrued liabilities	(7)	91	(287)	(716)
Deferred share units liability	-	-	(295)	-
	473	1,085	2,097	2,775
Change in non-cash investing working capital:				
Accounts receivable	-	70	-	531
Accounts payable and accrued liabilities	(36)	40	(181)	(976)
	(36)	110	(181)	(445)

12. RISK MANAGEMENT

a) The Company is exposed to the following risks:

i) Commodity price risk

Headwater enters into financial derivative contracts and physical delivery contracts to manage the risks associated with fluctuations in natural gas prices. The Company does not use derivative financial instruments for speculative purposes.

Financial derivatives

The Company has entered into the following outstanding financial derivative contracts as at November 6, 2020:

Commodity	Type (1) (2)	Term	Volume	Price
Natural Gas	NYMEX fixed price swap	Dec 2020- Mar 2021	1,000 mmbtu/d	Cdn $4.05/mmbtu
Natural Gas	NYMEX fixed price swap	Dec 2020- Mar 2021	1,000 mmbtu/d	Cdn $4.08/mmbtu
Natural Gas	NYMEX fixed price swap	Dec 2020- Mar 2021	1,000 mmbtu/d	Cdn $3.99/mmbtu
Natural Gas	NYMEX fixed price swap	Dec 2020- Mar 2021	1,000 mmbtu/d	Cdn $4.06/mmbtu
Natural Gas	NYMEX fixed price swap	Dec 2020- Mar 2021	1,000 mmbtu/d	Cdn $4.08/mmbtu
Natural Gas	AGT floating price swap (3)	Dec 2020- Mar 2021	2,500 mmbtu/d	NYMEX plus Cdn $3.82/mmbtu
Natural Gas	AGT floating price swap (4)	Dec 2020- Mar 2021	2,500 mmbtu/d	NYMEX plus Cdn $3.69/mmbtu
Natural Gas	AGT fixed price swap	Nov 2020	2,500 mmbtu/d	Cdn $5.00/mmbtu

(1) NYMEX = NYMEX Henry Hub
(2) AGT = Algonquin city-gates
(3) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn $3.82/mmbtu
(4) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn $3.69/mmbtu

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

	Three months ended September 30,		Nine months ended September 30,	
	2020	2019	2020	2019
	$	$	$	$
Gains (losses) on financial derivatives:				
- realized gains	-	-	3,937	2,898
- unrealized losses	(280)	(137)	(1,612)	(325)
Gains (losses) on financial derivatives	(280)	(137)	2,325	2,573

As at September 30, 2020, the fair value of the Company’s financial derivative contracts is a net liability of $131 thousand.

The fair values of these financial derivative contracts are sensitive to changes in the natural gas reference prices. Holding other assumptions constant, if NYMEX and AGT prices increased (decreased) by 10%, the fair value of the net financial derivative liability would increase (decrease) by $411 thousand.

During the second quarter of 2020, in order to establish a risk management facility to be able to enter into various financial derivative contracts with a new 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.

Fair value measurements

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 based on unadjusted quoted prices available in active markets for identical assets or liabilities as of the reporting date.
- Level 2 - Values are based on inputs, including quoted 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.

Assessment of the significance of an input to the fair value measurement requires judgment and may affect the placement within the fair value hierarchy.

The Company's financial instruments that are carried at fair value include its derivative financial instruments. Headwater's derivative financial instruments are classified as Level 2 measurements in the three-level fair value measurement hierarchy. The fair value of the derivative financial instruments relating to commodity contracts is determined by calculating the difference between the contracted price and published forward price curves as at the balance sheet date, and then multiplying this price differential by the contracted commodity volumes.

Headwater does not have any financial instruments classified as Level 1 or Level 3 that are carried at fair value. There were no transfers between the levels in the fair value hierarchy for the nine months ended September 30, 2020.

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

ii) Foreign currency risk

The Company is exposed to fluctuations in the exchange rate between the Canadian dollar and the U.S. dollar. Natural gas prices, condensate prices and transportation expenses are based upon reference prices denominated in U.S. dollars, while the Company's remaining expenses are denominated in Canadian dollars.

To manage a portion of foreign currency risk, the Company periodically enters into financial derivative contracts denominated in Canadian dollars.

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

(thousands of U.S. dollars)	September 30, 2020	December 31, 2019
	$	$
Cash	9	509
Accounts receivable	-	3,166
Financial instruments in U.S. dollars	9	3,675

iii) Credit risk

Headwater sells all its natural gas production to one large credit-worthy purchaser under normal industry payment terms. Headwater's receivables from joint operations partners are also subject to normal credit risks in the natural gas industry. As at September 30, 2020, the majority of the Company's accounts receivables were outstanding for less than 30 days. The average expected credit loss on the Company's accounts receivable was $nil as at September 30, 2020. Trade receivables generally have a 30-day term and the majority have been collected subsequent to period-end. As at September 30, 2020, the Company's receivables consisted of $nil (December 31, 2019 - $2,632 thousand) trade receivables, $5 thousand (December 31, 2019 - $276 thousand) from joint operations partners, $153 thousand (December 31, 2019 - $99 thousand) from interest receivables and $70 thousand (December 31, 2019 - nil) from sales tax and other government related receivables.

Cash and cash equivalents are held with banks with high credit-ratings assigned by international credit-rating agencies. Management believes the risk of loss is low.

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 following table details the contractual maturities of the Company's financial liabilities as at September 30, 2020:

	Within 1 year	1 to 4 years	Beyond 4 years
	$	$	$
Accounts payable and accrued liabilities	911	-	-
Financial derivatives	131	-	-
Total	1,042	-	-

As at September 30, 2020, the Company was holding cash and cash equivalents of $112,672 thousand. Cash and cash equivalents include guaranteed investment certificates ("GIC's") that are highly liquid as the GIC's are redeemable on demand without penalty.

Given the Company's available liquid resources and the Company's 2020 budget, management expects to have sufficient available funds to meet current and foreseeable financial liabilities.

b) Management of capital

Management's objectives when managing capital are to provide an adequate return to its shareholders and to safeguard the Company's ability to obtain financing and have access to capital. In the management of capital, the Company includes shareholders' equity and working capital. To facilitate the management of its capital structure, the Company prepares annual expenditure and operating budgets that are updated as necessary depending on success factors, industry conditions and cash flow provided by operations. These annual and updated budgets are approved by the board of directors. Headwater has the ability to adjust its capital structure by making modifications to its capital expenditure program.

The Company may elect to shut-in production of its New Brunswick CGU assets during periods of lower pricing in order to maximize cash flows over the life of the assets in accordance with its production optimization strategy. Headwater shut-in production on both May 1, 2020 and May 1, 2019 in accordance with this strategy.

The Company has not paid or declared any dividends.

13. COMMITMENTS

a) Gas sales

The Company has a long-term agreement to sell, at market rates, all of its natural gas produced from the McCully Field and surrounding areas in southern New Brunswick to Repsol for resale to natural gas markets in Maritimes Canada and the Northeast United States. The contract terminates on April 1, 2024.

b) Letters of credit

As at September 30, 2020, the Company had an irrevocable standby letter of credit issued by a Canadian chartered bank in the amount of $350 thousand. This standby letter of credit is recorded as restricted cash in current assets.

14. SUBSEQUENT EVENT

Transformational Property Acquisition

On November 6, 2020, the board of directors has approved Headwater entering into a definitive agreement with Cenovus Energy Inc. (“Cenovus”) to acquire the entirety of Cenovus’ position in the Marten Hills area of Alberta (the “Transaction”). Pursuant to the Transaction, Headwater will acquire 100% working interest in both the producing assets and undeveloped land. The consideration will consist of $35 million of cash in addition to 50 million common shares of Headwater and 15 million warrants each exercisable into one common share of Headwater. The warrants will be considered vested on closing with an exercise price of $2.00 and expire three years from the issuance date. The common shares and warrants will be valued using Headwater’s closing share price on the closing date of the Transaction. Concurrently with the closing of the Transaction, Headwater will cause two representatives from Cenovus to be appointed as directors of the Company.

Cenovus will retain a gross overriding royalty on the core development area and on the exploratory lands. Headwater will be committed to spend $100 million in capital expenditures on the acquired lands by December 31, 2022.

The Transaction is subject to the approval by the shareholders of Headwater, certain regulatory and other authorities and to the satisfaction or waiver of other customary closing conditions. The Transaction has an effective date of October 1, 2020 and is expected to close on December 22, 2020. Pursuant to the execution of the definitive agreement, Headwater will pay a $10 million deposit to Cenovus which will be credited against the consideration on closing.