Management's Report

The management of Headwater Exploration Inc. has prepared the accompanying financial statements of Headwater Exploration Inc. in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board. Financial and operating information presented throughout the regulatory filings is consistent with that shown in the financial statements.

Management is responsible for the integrity and objectivity of the financial information. Where necessary, the financial statements include estimates that are based on management's informed judgments. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded, transactions are properly authorized and reliable accounting records are produced for financial purposes.

KPMG LLP, an independent firm of Chartered Professional Accountants was appointed by the Company's shareholders to conduct an audit of the financial statements. Their examination included such tests and procedures as they considered necessary to provide reasonable assurance that the financial statements are presented fairly in accordance with International Financial Reporting Standards.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. It exercises its responsibilities primarily through the Audit Committee, which is comprised of three independent directors. The Committee meets regularly with management and with the independent auditors to satisfy itself that management's responsibilities are properly discharged, to review the financial statements and to recommend that the financial statements be presented to the Board of Directors for approval.

The Audit Committee has reviewed the financial statements and recommended their approval to the Board of Directors. The Board has approved the financial statements for issuance to the Company's shareholders.

(signed) "*Neil Roszell*"

Neil Roszell
Chief Executive Officer and Chairman

(signed) "*Ali Horvath*"

Ali Horvath, CPA, CA
Vice President Finance and Chief Financial Officer

March 10, 2021

KPMG LLP
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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Headwater Exploration Inc.

Opinion

We have audited the financial statements of Headwater Exploration Inc. (the "Entity"), which comprise:

- the statement of financial position as at December 31, 2020
- the statement of income and comprehensive income for the year then ended
- the statement of changes in shareholders' equity for the year then ended
- the statement of cash flows for the year then ended
- and notes to the financial statements, including a summary of significant accounting policies

(Hereinafter referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Entity as at December 31, 2020, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS).

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the "*Auditors' Responsibilities for the Audit of the Financial Statements*" section of our auditors' report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

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Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements for the year ended December 31, 2020. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

We have determined the matters described below to be the key audit matters to be communicated in our auditors' report.

Evaluation of the acquisition-date fair value of property, plant and equipment acquired through a business combination

Description of the matter

We draw attention to note 2, note 3 and note 5 to the financial statements. The Entity acquired property, plant and equipment ("PP&E") through a business combination. The acquisition date fair value for the PP&E was $119,636 thousand. The determination of the acquisition-date fair value of PP&E involves significant estimates, including the cash flows associated with the proved and probable oil and gas reserves and the discount rates.

The estimation of the cash flows associated with the proved and probable oil and gas reserves requires the expertise of an independent third party reserve evaluator, and includes significant assumptions related to:

- Forecasted production
- Forecasted operating costs
- Forecasted royalty costs
- Forecasted future development costs
- Forecasted oil and gas commodity prices.

The Entity engages an independent third party reserve evaluator to estimate the cash flows associated with the proved and probable oil and gas reserves.

Why the matter is a key audit matter

We identified the evaluation of the acquisition-date fair value of PP&E acquired through a business combination as a key audit matter. Significant auditor judgment was required in evaluating the results of our audit procedures regarding the estimate of the cash flows associated with the proved and probable oil and gas reserves and the discount rates.

How the matter was addressed in the audit

The primary procedures we performed to address this key audit matter included the following:

With respect to the estimate of the cash flows associated with the proved and probable oil and gas reserves:

- We evaluated the competence, capabilities and objectivity of the independent third party reserve evaluator engaged by the Entity
- We compared the forecasted oil and gas commodity prices to those published by other independent third party reserve evaluators
- We evaluated the appropriateness of forecasted production and forecasted operating costs, royalty costs and future development costs by comparing to 2020 historical results. We took into account changes in conditions and events affecting the Entity to assess the adjustments or lack of adjustments made by the Entity in arriving at the assumptions.

We involved valuation professionals with specialized skills and knowledge, who assisted in

- Evaluating the appropriateness of the Entity's discount rates by comparing the discount rates to market and other external data
- Assessing the reasonableness of the Entity's estimate of the acquisition-date fair value of PP&E by comparing the Entity's estimate to market metrics and other external data.

Assessment of the recoverable amount of the New Brunswick cash generating unit

Description of the matter

We draw attention to note 2, note 3 and note 7 to the financial statements. The Entity assesses at each reporting date whether there is an indication that property, plant and equipment within a cash generating unit (the "CGU") may be impaired or that historical impairment may be reversed. The Entity has recorded an impairment reversal of $15,054 thousand related to its New Brunswick CGU. The determination of the recoverable amount of a CGU involves significant estimates, including the cash flows associated with the proved and probable natural gas reserves and the discount rates.

The estimation of the cash flows associated with the proved and probable natural gas reserves requires the expertise of an independent third party reserve evaluator, and includes significant assumptions related to:

- Forecasted production
- Forecasted operating costs

- Forecasted royalty costs
- Forecasted natural gas commodity prices.

The Entity engages an independent third party reserve evaluator to estimate the cash flows associated with the proved and probable oil and gas reserves of the New Brunswick CGU.

Why the matter is a key audit matter

We identified the assessment of the recoverable amount of the New Brunswick CGU as a key audit matter. Significant auditor judgement was required in evaluating the results of our audit procedures with respect to the estimate of the cash flows associated with the proved and probable natural gas reserves and the discount rates.

How the matter was addressed in the audit

The primary procedures we performed to address this key audit matter included the following:

With respect to the estimate of the cash flows associated with the proved and probable natural gas reserves:

- We evaluated the competence, capabilities and objectivity of the independent third party reserve evaluator engaged by the Entity
- We compared the forecasted natural gas commodity prices to those published by other independent third party reserve evaluators
- We compared the 2020 actual production and actual operating costs and royalty costs associated with New Brunswick CGU to those estimates used in the prior year's estimate of the cash flows associated with proved natural gas reserves to assess the Entity's ability to accurately forecast
- We evaluated the appropriateness of forecasted production and forecasted operating costs and royalty costs by comparing to 2020 historical results. We took into account changes in conditions and events affecting the Entity to assess the adjustments or lack of adjustments made by the Entity in arriving at the assumptions.

We involved valuation professionals with specialized skills and knowledge, who assisted in

- Evaluating the appropriateness of the Entity's discount rates by comparing the discount rates to market and other external data
- Assessing the reasonableness of the Entity's estimate of the recoverable amount of the New Brunswick CGU by comparing the Entity's estimate to market metrics and other external data.

Other Matter – Comparative Information

The financial statements for the year ended end December 31, 2019 were audited by another auditor who expressed an unmodified opinion on those financial statements on March 25, 2020.

Other Information

Management is responsible for the other information. Other information comprises the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit and remain alert for indications that the other information appears to be materially misstated.

We obtained the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions as at the date of this auditors' report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in the auditors' report.

We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards (IFRS), and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Auditors' Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.

  The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.
- Determine, from the matters communicated with those charged with governance, those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditors' report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our auditors' report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this auditors' report is Shane Doig.

KPMG LLP

Chartered Professional Accountants

Calgary, Canada
March 10, 2021

HEADWATER EXPLORATION INC.
Statements of Financial Position

(thousands)	December 31, 2020 $	December 31, 2019 $
ASSETS		
Current assets		
Cash and cash equivalents	76,772	60,957
Restricted cash (notes 18 & 20)	1,827	680
Accounts receivable (note 18)	5,475	3,007
Financial derivative receivable (note 18)	74	1,481
Inventories	571	-
Prepaids and deposits	448	287
Total current assets	85,167	66,412
Exploration and evaluation assets (note 6)	27,101	3,816
Property, plant and equipment (note 7)	187,664	54,118
Deferred income tax asset (note 13)	-	3,286
Right-of-use assets (note 8)	418	289
Other assets (note 5)	335	-
Restricted cash (note 20)	-	350
Total assets	300,685	128,271
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 18)	4,105	1,378
Deferred share units liability (note 12)	91	322
Current portion of lease liability (note 8)	138	90
Warrant liability (note 10)	10,305	-
Total current liabilities	14,639	1,790
Lease liability (note 8)	298	195
Decommissioning liability (note 9)	16,718	11,976
Total liabilities	31,655	13,961
Shareholders' Equity		
Capital stock (note 11)	387,393	247,332
Warrants (note 11)	7,659	-
Contributed surplus	11,659	11,366
Deficit	(137,681)	(144,388)
Total shareholders' equity	269,030	114,310
Total liabilities and shareholders' equity	300,685	128,271

Commitments (note 20)
Subsequent events (note 21)

See accompanying notes to the financial statements

Approved on behalf of the Board of Directors:

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

(signed) "Neil Roszell"
Neil Roszell
Director

HEADWATER EXPLORATION INC.
Statements of Income and Comprehensive Income

	Year ended December 31,	
	2020	2019
(thousands, except per share data)	$	$
REVENUE		
Sales (note 14)	9,499	9,333
Royalties	(656)	(230)
	8,843	9,103
Gains on financial derivatives (note 18)	4,108	4,176
	12,951	13,279
EXPENSES		
Blending and transportation	1,115	-
Production	2,899	2,611
General and administrative	2,835	3,002
Transaction costs (notes 5 & 11)	7,330	-
Remeasurement loss on warrant liability (note 10)	4,289	-
Stock-based compensation	1,477	337
Depletion and depreciation (note 7)	5,895	4,762
Exploration and evaluation expense (note 6)	3,821	-
Impairment reversal (note 7)	(15,054)	(322)
Other write-downs and losses	27	151
	14,634	10,541
Interest income and other (note 15)	1,113	830
Income (loss) before income taxes	(570)	3,568
Deferred income tax expense (recovery) (note 13)	(7,277)	753
Net income and comprehensive income	**6,707**	**2,815**
Net income per share (note 11)		
Basic	0.05	0.03
Diluted	0.05	0.03

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Statements of Cash Flows

	Year ended December 31,	
	2020	2019
(thousands)	$	$
OPERATING		
Net income	6,707	2,815
Items not involving cash:		
Unrealized (gains) losses on financial derivatives (note 18)	1,407	(485)
Remeasurement loss on warrant liability (note 10)	4,289	-
Stock-based compensation	1,477	337
Depletion and depreciation	5,895	4,762
Exploration and evaluation expense	3,821	-
Impairment reversal	(15,054)	(322)
Other write-downs and losses	27	151
Accretion and finance charges (notes 8 & 9)	160	219
Deferred income tax expense (recovery)	(7,277)	753
Decommissioning liabilities settled (note 9)	-	(24)
Change in non-cash operating working capital (note 17)	(1,222)	655
Cash flows provided by (used in) operating activities	230	8,861
FINANCING		
Issue of common shares, net of costs (note 11)	47,964	-
Purchase of common shares under normal course issuer bid (note 11)	-	(549)
Payment of lease liability (note 8)	(110)	(148)
Proceeds from exercise of stock options (note 11)	2,077	18
Proceeds from exercise of warrants (note 11)	58	-
Cash flows provided by (used in) financing activities	49,989	(679)
INVESTING		
Capital expenditures – exploration and evaluation (note 6)	(469)	(391)
Capital expenditures – property and equipment (note 7)	(1,808)	(294)
Property acquisition (note 5)	(32,781)	-
Restricted cash	(797)	-
Proceeds on sale of assets	-	97
Change in non-cash investing working capital (note 17)	1,451	(289)
Cash flows used in investing activities	(34,404)	(877)
Change in cash and cash equivalents	15,815	7,305
Cash and cash equivalents, beginning of year	60,957	53,652
Cash and cash equivalents, end of year	76,772	60,957

Cash and cash equivalents consist of:		
Cash	61,772	44,330
Short-term investments	15,000	16,627
Cash and cash equivalents, end of year	76,772	60,957

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Statements of Changes in Shareholders' Equity

(thousands)	Note	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	11	(549)	-	-	-	(549)
Exercise of stock options	11	26	-	(8)	-	18
Stock-based compensation		-	-	326	-	326
Net income		-	-	-	2,815	2,815
Balance at December 31, 2019		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Balance at January 1, 2020		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Issued on Recapitalization Transaction	11	50,000	-	-	-	50,000
Allocation to Warrants	11	(7,680)	7,680	-	-	-
Issued on Acquisition	11	96,500	-	-	-	96,500
Share issue costs	11	(2,036)	-	-	-	(2,036)
Exercise of stock options	11	3,198	-	(1,121)	-	2,077
Exercise of Warrants	11	79	(21)	-	-	58
Stock-based compensation		-	-	1,414	-	1,414
Net income		-	-	-	6,707	6,707
Balance at December 31, 2020		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Notes to the Financial Statements

As at and for the years ended December 31, 2020 and 2019

(All tabular amounts in thousands, unless otherwise stated)

1. NATURE OF OPERATIONS AND GENERAL INFORMATION

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), whereby 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 11 of these audited annual financial statements.

On December 2, 2020, Headwater closed the Acquisition (defined herein) whereby the Company acquired the entirety of Cenovus' position in the Marten Hills area of Alberta for estimated total consideration of $135.3 million, comprised of $32.8 million of cash, $96.5 million of common shares and $6.0 million of warrants. Details of the Acquisition are provided in note 5 of these audited annual financial statements.

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

2. BASIS OF PREPARATION

Statement of compliance

These audited annual financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. The accounting policies discussed in note 3 have been consistently applied for all periods presented in these financial statements.

These audited annual financial statements were approved and authorized for issue by the Company's Board of Directors on March 10, 2021.

Basis of measurement, functional and presentation currency

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

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

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 amount 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. Actual results may differ from the estimated amounts as future confirming events occur and more information is obtained by management. The Company has identified the following areas requiring significant judgments, assumptions or estimates.

Impact of COVID-19

In March 2020, the World Health Organization declared a global pandemic following the emergence and rapid spread of a novel strain of the coronavirus ("COVID-19"). The outbreak and subsequent measures enforced to limit the spread of the pandemic contributed to volatility in financial markets. The pandemic has adversely impacted global commercial activity, including significantly reducing worldwide demand for crude oil and natural gas.

The full extent of the impact of COVID-19 on the Company's operations and future financial performance, including the recoverable amounts of its exploration and evaluation assets and property, plant and equipment, is currently unknown. It will depend on future developments that are uncertain and unpredictable, including the duration and spread of COVID-19, the global roll-out of a vaccine and the virus' continued impact on financial markets.

The outbreak and current market conditions have increased the complexity of estimates and assumptions used to prepare the audited annual financial statements, particularly related to recoverable amounts. There is a high degree of uncertainty regarding the estimates and assumptions used in determining the recoverable amounts including future crude oil and natural gas commodity prices, foreign exchange rates, discount rates and the Company's future crude oil and natural gas production. As the understanding of the longer-term impacts of COVID-19 develops, the estimates and assumptions used in determining the recoverable amounts could change and there could be a material financial impact in future periods.

Alternative Sources of Energy

The Company has considered the impacts of climate change and 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 impairment of its oil and gas properties. The measurement of impairment for the Company's oil and gas properties was based on proved plus probable reserves where the majority of the cash flows incorporated into the estimate of the recoverable amount are estimated to be realized in the next ten years. At December 31, 2020, a specific adjustment to the recoverable amount to account for the risk of climate change was not considered necessary, however, the recoverable amount is based on an estimated period of cash flows that indirectly reflects changing energy demands and the discount rate applied in the impairment test incorporates the current cost of capital in the energy industry which indirectly reflects current market trends around climate change. The ultimate period in which global energy markets can transition from carbon-based sources to alternative energy is highly uncertain.

a) Critical Judgments in Applying Accounting Policies

Business Combinations

Business combinations are accounted for using the acquisition method of accounting. The determination of fair value is estimated based on information available at the date of acquisition and requires management to make assumptions and estimates about future events. The assumptions and estimates with respect to determining the fair value of exploration and evaluation assets and property, plant and equipment acquired generally require the most judgment and include estimates of the cash flows associated with proved and probable reserves acquired which is impacted by assumptions related to forecasted production, forecasted operating and royalty costs, future development costs, future crude oil and natural gas commodity prices,

foreign exchange rates, and discount rates. Assumptions are also required to determine the fair value of decommissioning liabilities associated with the properties. Changes in any of these assumptions or estimates used in determining the fair value of acquired assets and liabilities could impact the amounts assigned to assets, liabilities (including deferred income tax liabilities) in the acquisition equation. Future net income (loss) will be affected as the fair value on initial recognition impacts future depletion expense, as well as the risk of potential impairment in future periods.

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.

The Company's CGUs as at December 31, 2020 include its New Brunswick CGU consisting of its McCully assets and its Alberta CGU comprised of its Marten Hills assets.

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.

Deferred income taxes

Judgment is required to assess the recognition of deferred income tax assets which is based on the probability that future taxable profits will be sufficient to utilize the underlying taxable amounts. Changes in the estimated future taxable profits, which is based on the cash flows associated with the Company's proved reserves, could materially impact the Company's deferred income tax assets recognized.

b) Key Sources of Estimation Uncertainty

Recoverability of asset carrying value and valuation of reserves

At each reporting date, the Company assesses its property, plant and equipment and exploration and evaluation 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 include the following:

i) 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 reserves revisions.

ii) 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.

iii) 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.

iv) 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, property, plant, and equipment acquired in business combinations, deferred income taxes 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 (NI) 51-101, "Standards of Disclosure for Oil and Gas Activities". 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, foreign exchange rates and volatility.

The estimated fair value of the warrant liability, which is considered a financial instrument, uses the Monte Carlo simulation pricing model which is based on assumptions including volatility, risk-free interest rate and the expected term.

Valuation of Warrants and stock options

The estimated fair values of the Warrants issued as part of the non-brokered private placement in connection with the Recapitalization Transaction and stock options issued under the Company's stock option plans were based on the Black-Scholes pricing model incorporating assumptions on volatility, risk-free interest rate, forfeiture rate and the expected term.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared by management using the following IFRS accounting policies. The accounting policies have been applied consistently for all periods presented in these audited annual financial statements.

a) Joint interest

A portion of the Company's exploration, development and production activities is conducted jointly with others through an unincorporated joint venture. These financial statements reflect only the Company's proportionate interest of these jointly controlled assets and the proportionate share of the relevant revenue and related costs.

b) Foreign currency translation

Foreign currency transactions are translated using the exchange rate prevailing at the date of transaction. Monetary assets and liabilities that are denominated in foreign currencies are translated into Canadian dollars at each reporting date at the exchange rate prevailing on the Statement of Financial Position date. Foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation of monetary assets and liabilities on the Statement of Financial Position date are recognized in the Statement of Income and Comprehensive Income.

c) Business Combinations

Business combinations are accounted for using the acquisition method. The identifiable net assets acquired are measured at their fair value at the date of acquisition.

Transaction costs associated with the acquisition are expensed when incurred.

d) Cash and cash equivalents and restricted cash

Cash and cash equivalents include cash held with Canadian chartered banks in highly liquid investments.

Restricted cash primarily consists of cash held for standby letters of credit in respect to transportation arrangements and cash collateral required for certain financial derivative commodity contracts.

e) Financial instruments

Headwater's financial assets and liabilities are classified into two categories: amortized cost and fair value though profit or loss ("FVTPL"). The classification of financial assets is determined by the characteristics of the contractual cash flows. Headwater does not classify any of its financial instruments as fair value through other comprehensive income.

Financial assets and liabilities are measured at fair value on initial recognition, which is typically the transaction price, unless a financial instrument contains a significant financing component.

i) Financial assets at amortized cost

Financial assets at amortized costs include accounts receivable, cash and cash equivalents and restricted cash. Account receivable are financial assets held to collect contractual cash flows that represent payments of principal and interest only. The carrying values of accounts receivable approximate fair values because of the short term to maturity.

The Company measures expected credit losses using a lifetime expected loss allowance for accounts receivable with expected lifetime losses recognized from initial recognition. Each period, Headwater assesses the expected credit losses on a forward-looking basis.

ii) Financial liabilities at amortized cost

Financial liabilities at amortized cost include accounts payable and accrued liabilities. Accounts payable and accrued liabilities approximate the fair values because of the short term to maturity.

iii) Fair value through profit or loss

The Company's financial derivative commodity contracts are classified as fair value through profit or loss and are recognized at fair value based on quoted market prices at each reporting date. The Company does not apply hedge accounting to its derivative instruments.

The Company's warrant liability is classified as fair value through profit or loss and is recognized at fair value. The warrant liability is included in current liabilities with any changes in fair value recognized as remeasurement of warrant liability in the Statement of Income and Comprehensive Income.

f) Inventories

Inventories consist of crude oil products, diluent and materials and supplies. Inventory is valued at the lower of cost and net realizable value. The cost of crude oil is determined on a weighted average basis and the cost of diluent is based on the purchase price. Costs include the direct and indirect expenditures incurred in the normal course of business in bringing the item or product to its existing condition and location. Net realizable value is the estimated selling price less applicable selling expenses. If the carrying value exceeds the net realizable value, a write-down is recognized. The write-down may be reversed in a subsequent period if the inventory is still on hand and the circumstances which caused the write-down no longer exist.

g) Exploration and evaluation ("E&E") assets

Once the legal right to explore has been acquired, costs directly associated with an exploration activity are capitalized as E&E assets and grouped by licensed exploration area. Capitalized costs include lease acquisition costs, geological and geophysical expenses and the portion of general and administrative expenses and estimated decommissioning liabilities directly related to the exploration activities. Costs are capitalized until the technical feasibility and commercial viability of extracting a mineral resource are demonstrable and the presence of reserves has been established, after which capitalized costs are transferred to property, plant and equipment following an assessment for impairment.

All E&E assets are subject to a review for impairment when facts and circumstances suggest that the carrying amount of the asset may exceed its recoverable amount. When the Company believes that E&E assets are no longer viable for future economic development, the assets are written off to the Statement of Income and Comprehensive Income.

Exploration and evaluation assets are not depleted.

h) Property, plant and equipment

Oil and gas properties

Property, plant, and equipment primarily consists of crude oil and natural gas development and production assets and is measured at cost less accumulated depletion and depreciation and accumulated impairment losses and reversals. These costs include property acquisitions, development drilling, completion and equipping costs, infrastructure costs, estimated decommissioning liabilities, directly attributable overhead and administration costs and transfers from E&E. In addition, borrowing costs incurred for the construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the assets for their intended use.

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of PP&E are recognized as oil and gas properties only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in net income as incurred.

Costs of planned major inspections, overhaul and turnaround activities that maintain PP&E and benefit future years of operations are capitalized and depreciated on a straight-line basis over the period to the next turnaround. Recurring planned maintenance activities performed on shorter intervals are expensed.

When an asset in property, plant and equipment is disposed of the carrying amount of the asset is derecognized with any gain or loss recorded in the Statement of Income and Comprehensive Income.

Depletion and depreciation

Once commercial production has commenced, depletion of oil and gas properties is calculated using the unit-of-production basis over the estimated proved plus probable reserves before royalties, as determined by qualified independent reserves engineers. Depletion is calculated at the CGU level and takes into account expenditures incurred to date together with future development costs to develop the proved plus probable reserves.

Concurrent with the closing of the Acquisition, management changed the basis of reserves used in its depletion calculation of its McCully assets from proved reserves to proved plus probable reserves as this is more aligned with the basis management uses to assess the business. A change in the basis of reserves constitutes a change in accounting estimate under IAS 8 with the effect of the change recognized prospectively. The change in estimate resulted in a decrease of depletion expense of $112 thousand recorded in the Statement of Income and Comprehensive Income for the year ended December 31, 2020.

For office and other assets, depreciation is recognized in the Statement of Income and Comprehensive Income on a declining balance basis over the estimated useful lives of each part of an item of property, plant and equipment.

The estimated useful lives for depreciable assets are as follows:

Asset	**Method**	**Basis**
Buildings	Declining Balance	4%
Equipment and furniture	Declining Balance	10% - 30%
Computer hardware and software	Declining Balance	30% - 50%

Depreciation rates and useful lives are reviewed on an annual basis.

i) Deferred taxes

Deferred income tax assets are recognized to the extent that it is probable that future taxable profits will be sufficient to utilize the underlying taxable amount using the liability method of accounting. Deferred income tax is recognized for the temporary differences between the tax basis and carrying value of assets and liabilities. Deferred income tax is measured using the enacted or substantively enacted tax rates expected to be in effect when the deferred income tax assets are estimated to be realized or the deferred income tax liabilities are estimated to be settled.

j) Leases

The Company recognizes a right-of-use asset and a lease liability at the lease commencement date. The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred, less any incentives received. The right-of-use asset is subsequently depreciated on a straight-line basis over the lease term. The carrying amount is reviewed for impairment at each reporting period.

The lease liability is initially measured at the present value of future lease payments, discounted using the interest rate implicit in the lease, if applicable, or the Company's incremental borrowing rate. The lease liability is subsequently measured at amortized cost using the effective interest method. It is remeasured if the Company changes its assessment of whether it will exercise a purchase, extension, or termination option with a corresponding adjustment to the carrying amount of the right-of-use asset.

Lease payments are allocated between the lease liability and finance charges. Cash outflows for repayment of the principal portion of the lease liability is classified as cash flows provided by financing activities. The interest portion of the lease payments is classified as cash flows provided by operating activities.

The Company does not recognize assets and lease liabilities for short-term leases with a term of twelve months or less, and leases of low value assets. The lease payments associated with these leases are recognized as an expense in the Statement of Income and Comprehensive Income over the lease term.

k) Provisions

Decommissioning liabilities

A decommissioning liability is recognized for the present value of the future cost of abandoning oil and gas wells or facilities and is calculated based on management's best estimate of the expenditure using a combination of publicly available industry benchmarks and internal site-specific information. A

decommissioning liability is recognized only when a legal or constructive obligation exists. The liability is measured at each reporting date at the fair value of the estimated expenditures expected to settle the obligation using a risk-free interest rate. An equivalent amount is capitalized as part of exploration and evaluation assets or property, plant and equipment and depleted along with the related asset.

Changes in the estimated timing of settlement or future cash flows are dealt with prospectively by recording an adjustment to the decommissioning liability and a corresponding adjustment to the related asset. The unwinding of the discount on the decommissioning liability is included as an expense item in interest income and other in the Statement of Income and Comprehensive Income. Actual expenditures are charged against the liability as incurred.

General

Provisions are recognized when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and the obligation can be reliably estimated. Provisions are measured at management's best estimate of the expenditure required to settle the obligation and are discounted to present value where the effect is material.

l) Capital stock

Common shares are classified as equity. Transaction costs directly attributable to the issuance of common shares are recognized as a reduction of shareholders' equity, net of any related income tax.

m) Revenue recognition

The Company generates revenue from the sale of commodities which include crude oil, natural gas and natural gas liquids ("NGLs"). Revenue is recorded when control is transferred to the buyer which is usually when legal title passes to the external party. The transaction price for variable priced contracts is based on the commodity price index, adjusted for quality, delivery location and other factors, whereby each component of the pricing formula can be either fixed or variable, depending on the contract terms. The amount of revenue recognized is based on the agreed transaction price, whereby any variability in revenue relates specifically to the Company's efforts to transfer production, and therefore the resulting revenue is allocated to the production delivered in the period during which the variability occurs. As a result, none of the variable consideration is considered constrained.

Headwater's crude oil, natural gas and NGLs revenue do not contain significant financing components and payments are typically due 25 days following the month of delivery.

Each contract is evaluated based on the nature of the performance obligations, including the Company's role as either principal or agent. Where the Company acts as principal, revenue is recognized on a gross basis. Where the Company acts as agent, revenue is recognized on a net basis.

Gathering, processing and transportation

The Company has collaborative arrangements with its joint venture partner, Nutrien Inc. ("Nutrien") to gather, process and transport Nutrien's working interest share of natural gas production from the McCully field through Headwater's production facilities. The gathering, processing and transportation fees are calculated based on the use of these facilities and include a recovery of capital and a recovery of operating expenses.

Gathering, processing and transportation fees are recognized when the gathering, processing and transportation services have been provided, which coincides with the month the natural gas is produced.

n) Transportation and blending

Transportation services procured by Headwater are recognized in blending and transportation expense.

Headwater is required to purchase commodity products from third parties to utilize in blending activities. Headwater subsequently sells the blended products to its customers. These transactions are presented in

revenue with the related expense included in blending and transportation expense recognized in the Statement of Income and Comprehensive Income.

The costs associated with the transportation of crude oil, natural gas and NGLs, including the cost of diluent used in blending, are recognized when the product is sold.

o) Impairment of non-financial assets

At each reporting date, the Company assesses whether there is an indication that an asset or CGU may be impaired or that historical impairment may be reversed. A CGU includes a group of assets that generates cash flows that are largely independent of the cash inflows from other groups of assets. A CGU may also include certain aggregated E&E assets. If any indication of impairment exists, the Company estimates the asset's or CGU's recoverable amount. The recoverable amount is the higher of an asset's or CGU's fair value less costs of disposal ("FVLCD") and its value-in-use. When the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is written down to its recoverable amount with the impairment loss recognized in the Statement of Income and Comprehensive Income.

A previously recognized impairment loss is reversed if there has been a change in the assumptions used to determine the asset's or CGU's recoverable amount when the impairment loss was initially recognized. However, the amount of the impairment loss reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been recognized, net of depletion expense, had no impairment loss been recognized for the asset in prior years. Any reversal of previously recognized impairment losses is recognized in the Statement of Income and Comprehensive Income.

p) Stock-based compensation

The Company records stock-based compensation expense for stock options granted to directors, officers, employees and consultants using the fair value method. The fair value of each vesting installment of the stock options granted is determined using the Black-Scholes option pricing model. Stock-based compensation expense is calculated over the vesting period based on the number of stock options expected to vest. Forfeiture estimates are based on historical information and are reviewed at each reporting date, with any impact recognized immediately in the Statement of Income and Comprehensive Income. Stock-based compensation expense is recorded in the Statement of Income and Comprehensive Income with a corresponding increase to contributed surplus. When stock options are exercised the consideration received and the amount previously recognized in contributed surplus are recorded as an increase to capital stock.

The fair value of deferred share units paid to directors is calculated based on the weighted average share price of the Company's common shares over the five previous trading days. At each reporting period, the deferred share units outstanding are measured at the Company's share price at that date. The fair value of the deferred share units granted and any changes in their fair value during the period are recognized in stock-based compensation expense in the Statement of Income and Comprehensive Income with a corresponding amount recorded in deferred share units liability in the Statement of Financial Position.

q) Government grants

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. The Company claimed a total of $439 thousand in 2020 which is recorded in production expense and general and administrative expenses.

r) Net income per share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the year. For the diluted net income per share calculation, the weighted average number of common shares outstanding is adjusted for the potential number of common shares which may have a dilutive effect on net income per share. The weighted average number of diluted shares

is calculated in accordance with the treasury stock method. The treasury stock method assumes that the proceeds received from the exercise of all potentially dilutive instruments are used to repurchase common shares at the average market price.

4. SUMMARY OF NEW ACCOUNTING POLICIES AND DISCLOSURES

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. 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 acquisition is accounted for as a business combination.

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 audited annual financial statements.

Future accounting pronouncements

On January 23, 2020, the IASB announced an amendment 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, 2023. 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.

The Company does not plan to early adopt any amendments issued but not yet effective.

5. PROPERTY ACQUISITION

Marten Hills Property Acquisition

On November 8, 2020, the Company entered into a purchase and sale agreement with Cenovus Energy Inc. ("Cenovus") to acquire (the "Acquisition") the entirety of Cenovus' position in the Marten Hills area of Alberta (the “Acquired Assets”). The Acquisition was completed on December 2, 2020 (the “Closing Date”) for estimated total consideration of $135.3 million, comprised of $32.8 million of cash (inclusive of interim adjustments), $96.5 million of common shares valued using Headwater’s closing share price on the Closing Date and $6.0 million of warrants. The effective date of the Acquisition was October 1, 2020.

The Acquired Assets include 100% working interest in Marten Hills heavy oil properties and undeveloped land. The Company assumed certain transportation commitments from Cenovus and is required to spend $100 million in capital expenditures on the Acquired Assets by December 31, 2022 (see note 20).

Headwater assessed the acquisition and determined it to constitute a business combination in accordance with IFRS 3. The table below summarizes the estimated fair value of the identifiable assets acquired and liabilities assumed:

Cash	$ 32,781
Common shares	96,500
Warrants	6,016
Total consideration	**135,297**
Working capital	961
Other assets – pipeline linefill	335
Exploration and evaluation assets	26,637
Property, plant and equipment	119,636
Decommissioning liabilities	(1,709)
Deferred income tax liability	(10,563)
Fair value of net assets acquired	**135,297**

Estimates for the fair value of consideration issued as well as the fair value of identifiable assets and liabilities acquired are management’s best estimates based on information available at the time of preparing these financial statements. The reader is cautioned that future revisions to these estimates over the measurement period (one year from the Closing Date of the Acquisition) could result in a material change from the amounts reported herein.

The fair value of PP&E acquired was estimated using the present value of the estimated cash flows associated with proved and probable oil and gas reserves and discounted at 11% (Level 3 fair value inputs). The discount rate used was determined based on a peer group weighted average cost of capital factoring in risks specific to the types of reserves. The projected cash flows were derived from a reserves report on the Acquired Assets which was prepared by an independent third party reserves evaluator.

The fair value of PP&E recognized is sensitive to the discount rate used in the calculation. The table below summarizes the fair value of PP&E calculated at various discount rates (holding all other assumptions constant), and the resulting deferred income tax liability recognized.

Fair Value	10%	12%
Property, plant and equipment	124,580	116,967
Deferred income tax liability	(12,099)	(9,733)

The fair value of the exploration and evaluation assets acquired was estimated based on recent land sales in the Marten Hills area.

The fair value of the warrants issued was estimated using a Monte Carlo simulation pricing model. The warrants issued are considered a financial derivative carried at fair value through profit or loss. Refer to note 10 for the pricing assumptions used.

A deferred income tax liability was recognized on the Acquisition as a result of the acquired tax basis differing from the fair value of the Acquired Assets.

Other assets consist of pipeline linefill on a third party owned pipeline and are classified as non-current as the transportation contract expires in 2030.

The Statement of Income and Comprehensive Income includes the results of operations for the period following the close of the Acquisition on December 2, 2020. Headwater's net income for the year ended December 31, 2020 includes $4,400 thousand of heavy oil sales and $2,133 thousand of net operating income (heavy oil sales less royalties, blending and transportation expense and production expense). If the assets had been acquired on January 1, 2020, an additional $33,178 thousand of heavy oil sales and $19,160 thousand of net operating income would have been included in the Statement of Income and Comprehensive Income for the year ended December 31, 2020. The additional heavy oil sales and net operating income are estimates and may not be representative of the results had the Acquisition actually occurred on January 1, 2020.

As at December 31, 2020, Headwater had incurred $2,948 thousand of transaction costs and $131 thousand of share issue costs to complete the Acquisition.

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

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

The following table reconciles the movements of the Company's exploration and evaluations assets for the year:

	December 31, 2020	December 31, 2019
	$	$
Balance, beginning of year	3,816	3,451
Acquired - property acquisition (note 5)	26,637	-
Additions	469	391
Expensed	(3,821)	-
Changes in decommissioning liabilities	-	(26)
Balance, end of year	27,101	3,816

Since May 27, 2016, the Company's McCully assets in New Brunswick have been subject to a moratorium on hydraulic fracturing. 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. As such, all E&E assets related to the Company's New Brunswick CGU were expensed in the year.

The Company concluded there are no indicators of impairment for its E&E assets at December 31, 2020.

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

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

	Oil and gas properties	Office and other assets	Total
Cost	$	$	$
Balance at December 31, 2018	323,586	2,695	326,281
Additions	250	44	294
Transfer to current assets	(32)	-	(32)
Sale of assets	(63)	(55)	(118)
Changes in decommissioning liabilities	707	-	707
Balance at December 31, 2019	324,448	2,684	327,132
Acquired - property acquisition (note 5)	119,636	-	119,636
Additions	1,753	55	1,808
Changes in decommissioning liabilities	2,884	-	2,884
Balance at December 31, 2020	448,721	2,739	451,460
Accumulated depletion, depreciation and impairment			
Balance at December 31, 2018	266,559	1,989	268,548
Depletion or depreciation expense	4,501	110	4,611
Impairment reversal	(322)	-	(322)
Transfer from current assets	57	-	57
Sale of assets	-	(31)	(31)
Write-down of assets	151	-	151
Balance at December 31, 2019	270,946	2,068	273,014
Depletion or depreciation expense	5,733	83	5,816
Impairment reversal	(15,054)	-	(15,054)
Write-down of assets	20	-	20
Balance at December 31, 2020	261,645	2,151	263,796
Net book value at December 31, 2019	53,502	616	54,118
Net book value at December 31, 2020	187,076	588	187,664

Future Development Costs

Future development costs required to develop proved plus probable reserves in the amount of $48.0 million were included in the depletion calculation for the Company's oil and gas properties for the year ended December 31, 2020 (December 31, 2019 – proved reserves of $2.6 million).

Impairment Reversal – New Brunswick CGU

For the year ended December 31, 2020, due to an increase in proved plus probable natural gas reserves as a result of improved recovery and technical revisions, the Company determined an indicator of impairment reversal was present for its New Brunswick CGU. As a result, the Company completed an impairment reversal test and recognized a reversal of previous impairment losses of $15,054 thousand.

The recoverable amount was estimated based on the FVLCD methodology which is calculated using the present value of the CGU's estimated cash flows associated with proved and probable nature gas reserves. The cash flow information was derived from a reserves report on the Company's McCully assets which was prepared by a third party reserves evaluator as of December 31, 2020. The projected cash flows used in the FVLCD calculation reflect market assessments of key assumptions as at December 31, 2020, including long-term forecasts for natural gas commodity prices, inflation rates and foreign exchange rates (Level 3 fair value inputs). Cash flow forecasts are also based on the Company's reserves and individual well production profiles, operating and royalty costs and future development costs. Royalty rates used in the FVLCD calculation are consistent with the New Brunswick government's royalty regime in effect as of December 31, 2020.

The discount rate used in the impairment reversal calculation was 13% and was determined based on a peer group weighted average cost of capital factoring in risks specific to the types of reserves. The carrying value of the New Brunswick CGU at December 31, 2020 was $37.4 million prior to any impairment reversal.

Forecast natural gas commodity pricing used in the FVLCD calculation as at December 31, 2020 reflects the benchmark prices set forth in the table below. McCully natural gas prices were calculated by adjusting the Algonquin city-gates natural gas prices to reflect the expected premiums received at Headwater's delivery point, transportation costs, if applicable, and heat content.

	2021	2022	2023	2024	2025	2026-2030	Thereafter
Algonquin city-gates ($US/mmbtu)	3.58	3.87	3.85	3.86	3.97	4.05 - 4.33	+2%/year
McCully ($CDN/mcf) [(1)]	6.47	6.47	6.51	5.74	6.37	6.50 – 7.12	+2%/year
Exchange rate ($US/$CDN)	0.77	0.77	0.76	0.76	0.76	0.76	0.76

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

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

As at December 31, 2020, a 1% increase in the discount rate and/or a five percent decrease in forecast operating cash flows would result in the following reduction to the Company's impairment reversal for the period:

	Decrease to impairment reversal
	$
1% increase in discount rate	(2,057)
5% decrease in cash flows	(2,576)
1% increase in discount rate and 5% decrease in cash flows	(4,535)

For the year ended December 31, 2019, due to an increase in proved plus probable natural gas reserves, the Company determined an indicator of potential impairment reversal was present for its New Brunswick CGU. As a result, the Company completed an impairment reversal test and recorded a recovery of $322 thousand.

Indicators of Impairment – Alberta CGU

The Company concluded there are no indicators of impairment for its Alberta CGU at December 31, 2020.

8. LEASES

Right-of-use ("ROU") asset

The following table reconciles the movements of the Company's ROU assets by class for the year:

	Office lease	Surface rentals	Vehicles	Total
	$	$	$	$
Cost				
Leases recognized at January 1, 2019	170	174	10	354
Additions	-	-	79	79
Balance at December 31, 2019	170	174	89	433
Additions	289	-	-	289
Dispositions	-	-	(89)	(89)
Balance at December 31, 2020	459	174	-	633
Accumulated depreciation				
Depreciation expense	113	8	23	144
Balance at December 31, 2019	113	8	23	144
Depreciation expense	86	8	22	116
Dispositions	-	-	(45)	(45)
Balance at December 31, 2020	199	16	-	215
Net book value at December 31, 2019	57	166	66	289
Net book value at December 31, 2020	260	158	-	418

Lease liability

The following table reconciles the movements of the Company's lease liabilities for the year:

	December 31, 2020	December 31, 2019
	$	$
Lease liability, beginning of year	285	-
Leases recognized at January 1, 2019	-	354
Additions	288	79
Dispositions	(38)	-
Interest expense	11	15
Payment of lease liability	(110)	(163)
Lease liability, end of year	436	285
Current portion of lease liability	138	90
Non-current portion of lease liability	298	195
Total lease liability	436	285

The weighted average discount rate as at December 31, 2020 is 5.0%. Payments under the Company's short-term leases were $50 thousand in 2020 which related to a short-term office space lease.

9. DECOMMISSIONING LIABILITY

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

	December 31, 2020	December 31, 2019
	$	$
Balance, beginning of year	11,976	11,100
Acquired - property acquisition (note 5)	1,709	-
Additions	50	-
Change in estimate [1]	606	681
Liabilities settled	-	(24)
Accretion	149	219
Revaluation of liabilities acquired	2,228	-
Balance, end of year	16,718	11,976

(1) Relates to changes in costs of future obligations, risk-free rate, inflation rate and time to abandonment. Of this amount, $127 thousand relates to the change in risk-free rate and inflation rate over the period.

The undiscounted amount of decommissioning liabilities acquired pursuant to the Acquisition is estimated to be approximately $3,756 thousand ($4,814 thousand inflated at 1.5%). The fair value of decommissioning liabilities acquired of $1,709 thousand was estimated by discounting the inflated cost estimates using a credit-adjusted risk-free rate of 6.3% on the Closing Date. The obligations acquired were subsequently remeasured in accordance with the Company's accounting policy, whereby decommissioning liabilities are discounted using a risk-free rate. Remeasurement of the decommissioning liabilities acquired at a risk-free rate of 1.2%, resulted in an increase in the present value of decommissioning liabilities acquired by $2,228 thousand.

The underlying cost estimates are derived from a combination of published industry benchmarks as well as site specific information. The Company has estimated the net present value of its total asset retirement obligations to be $16,718 thousand as at December 31, 2020 (December 31, 2019 - $11,976 thousand). The total future undiscounted amount of estimated cash flows required to settle these obligations is $23,611 thousand (December 31, 2019 - $16,998 thousand). Management estimates the settlement of these obligations will occur over the next 17 to 32 years. At December 31, 2020, a risk-free rate of 1.2% (December 31, 2019 – 1.8%) and an inflation rate of 1.5% (December 31, 2019 – 2.0%) were used to calculate the estimated fair value of the decommissioning liability.

Accretion of decommissioning liabilities is due to the passage of time and is presented within interest income and other in the Statement of Income and Comprehensive Income.

10. WARRANT LIABILITY

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

	December 31, 2020	December 31, 2019
	$	$
Warrant liability, beginning of year	-	-
Issued - property acquisition (note 5)	6,016	-
Remeasurement loss on warrant liability	4,289	-
Warrant liability, end of year	10,305	-

The warrant liability recognized on the Acquisition is a result of the 15 million warrants issued to Cenovus as partial consideration for the Acquired Assets. The warrants have an exercise price of $2.00 and expire in December 2023. Headwater has the right, after twelve months have elapsed from the Closing Date and provided the 20-day volume weighted average share price of the Company's common shares exceeds the exercise price of the warrants, to require Cenovus to exercise all or a portion of the then-outstanding warrants. The warrants issued were classified as a financial liability as a result of a cashless exercise provision. These warrants are exercisable and have therefore been presented as a current liability in the Statement of Financial Position. In no event will the Company be required to settle the warrants through a cash payment.

The fair value of the warrants on December 2, 2020 and on December 31, 2020 was determined using a Monte Carlo simulation pricing model with the following inputs:

	December 31, 2020	December 2, 2020
Share price	$2.39	$1.93
Risk-free interest rate	0.3%	0.3%
Expected life (years) (1)	0.9	1.0
Expected volatility (2)	56%	56%

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

11. CAPITAL STOCK

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

b) Issued and outstanding

	December 31, 2020		December 31, 2019	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of year	88,147	247,332	88,899	247,855
Recapitalization Transaction:				
Common shares issued for cash proceeds	54,347	50,000	-	-
Allocation to warrants	-	(7,680)	-	-
Common shares issued on Acquisition (note 5)	50,000	96,500	-	-
Share issue costs	-	(2,036)	-	-
Exercise of stock options	2,550	3,198	25	26
Exercise of Warrants	62	79	-	-
Purchase under normal course issuer bid	-	-	(777)	(549)
Balance, end of year	195,106	387,393	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.

Acquisition

Headwater issued 50 million common shares to Cenovus as part of the consideration for the Acquired Assets valued at a closing price of $1.93 per common share.

Stock Options

During the year ended December 31, 2020, 2,550 thousand stock options were exercised for 2,550 common shares for cash proceeds of $2,077 thousand. Contributed surplus related to the options exercised of $1,121 thousand was transferred to capital stock.

During the year ended December 31, 2019, 25 thousand stock options were exercised for 25 thousand common shares 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")

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.

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.

c) Warrants

	December 31, 2020		December 31, 2019	
	Number of Warrants	Amount	Number of Warrants	Amount
		$		$
Balance, beginning of year	-	-	-	-
Recapitalization Transaction:				
Warrants issued	21,739	7,680	-	-
Warrants exercised	(62)	(21)		
Balance, end of year	21,677	7,659	-	-

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 pricing 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.

As at December 31, 2020, the Warrants are fully vested. The Warrants will provide aggregate cash proceeds of approximately $20 million to the Company, if exercised by the holders.

d) Per share amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding. The Company uses the treasury stock method to determine the impact of dilutive securities. The reconciling items between basic and diluted average common shares outstanding are stock options and Warrants. Stock options and warrants issued to Cenovus that were out of the money were excluded from the diluted average common shares outstanding calculation.

	December 31, 2020	December 31, 2019
Weighted average shares outstanding		
Basic	139,379	88,472
Effect of stock options	262	285
Effect of Warrants	5,736	-
Diluted	145,377	88,757

12. STOCK-BASED COMPENSATION

a) Stock options

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

On March 25, 2020, the Company's Board of Directors approved a new share option plan ("New Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. Under the terms of the New Option Plan, an aggregate number of options equal to 8.0% of the aggregate number of issued and outstanding common shares less the aggregate number of common shares issuable pursuant to outstanding options under the Old Option Plan may be granted. The exercise price of each option granted under the New Option Plan is based on the closing price of the common shares on the TSX on the trading day prior to the date the option was granted and generally options 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 following table summarizes the changes in stock options outstanding during the year:

	December 31, 2020		December 31, 2019	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of year	3,490	$ 0.79	3,471	$ 0.79
Granted	7,905	$ 1.34	225	$ 0.70
Forfeited or expired	(867)	$ 0.79	(181)	$ 0.71
Exercised [1]	(2,550)	$ 0.82	(25)	$ 0.72
Options outstanding, end of year	7,978	$ 1.32	3,490	$ 0.79
Options exercisable, end of year	169	$ 0.70	2,466	$ 0.82

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

The total fair value of each option granted is estimated on the date of grant using the Black-Scholes pricing model with weighted average assumptions as follows:

	December 31, 2020	December 31, 2019
Weighted average fair value of options granted	$ 0.61	$ 0.37
Risk-free interest rate	0.3%	1.6%
Expected forfeiture rate	9.7%	6.7%
Expected life (years)	3.6	4.5
Expected volatility (1)	60%	66%

(1) During the year ended December 31, 2020, the expected volatility was estimated based on a peer group historical volatility.

The following table summarizes information regarding stock options outstanding as at December 31, 2020:

	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	273	2.7	$ 0.71	169	$ 0.70
$ 1.00 - $ 2.47	7,705	3.4	$ 1.34	-	-
Total	7,978	3.4	$ 1.32	169	$ 0.70

For the year ended December 31, 2020, the Company recorded stock-based compensation expense with an offsetting increase to contributed surplus of $1,414 thousand (December 31, 2019 - $326 thousand).

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 Company's outstanding DSUs during the year:

	December 31, 2020		December 31, 2019	
	Number of DSUs	Amount	Number of DSUs	Amount
		$		$
DSUs, beginning of year	447	322	388	311
DSUs redeemed during the year (1)	(409)	(535)	-	-
DSUs granted during the year	-	-	59	40
Fair value adjustment during the year	-	304	-	(29)
DSUs, end of year	38	91	447	322

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

The DSU liability as of December 31, 2020 of $91 thousand is based on a fair value of $2.39 per DSU, the Company's closing share price at December 31, 2020 (December 31, 2019 - $0.72 per DSU).

13. INCOME TAXES

Headwater was not required to pay income taxes in the current or prior year as the Company had sufficient tax deductions available to shelter taxable income.

The following table reconciles income taxes calculated at the weighted average Canadian statutory rate with the actual provision for deferred income taxes per the Statement of Income and Comprehensive Income:

	December 31, 2020	December 31, 2019
	$	$
Income (loss) before income taxes	(570)	3,568
Blended Canadian statutory tax rate	26.3%	29.0%
Expected income tax expense (recovery)	(150)	1,035
Increase (decrease) resulting from:		
Change in unrecognized benefit	(13,783)	(260)
Change in tax rates	6,515	21
Other	141	(43)
Deferred income tax expense (recovery)	(7,277)	753

The Canadian statutory tax rate per the rate reconciliation above represents the weighted average combined federal and provincial corporate tax rate.

The Alberta provincial tax rate changed due to a previously announced decrease from 10% to 8% that was accelerated to July 1, 2020.

The deferred tax asset is comprised of the following as at December 31, 2020:

Deferred income tax asset (liability)	December 31, 2019	Property Acquisition (note 5)	Movement through Statement of Income and Comprehensive Income	December 31, 2020
				$
E&E & PP&E	3,286	(11,094)	7,808	-
Decommissioning liability	-	531	(531)	-
	3,286	(10,563)	7,277	-

At December 31, 2020, the Company recognized a deferred tax asset of $nil (2019 - $3.3 million) and had $69.9 million (2019 - $99.8 million) of deductible temporary differences for which no deferred tax asset was recognized.

14. SALES

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

	December 31, 2020	December 31, 2019
	$	$
Heavy oil	4,400	-
Natural gas	4,466	8,767
Gathering, processing and transportation	579	459
NGLs	54	107
	9,499	9,333

Substantially all of the Company's heavy oil, natural gas and NGLs revenues for the year ended December 31, 2020 are derived from variable priced contracts based on index prices.

Included in accounts receivable as at December 31, 2020 is $4,500 thousand (December 31, 2019 - $2,632 thousand) of accrued heavy oil, natural gas and NGLs sales related to December 2020 production.

15. INTEREST INCOME AND OTHER

Interest income and other consists of the following:

	December 31, 2020	December 31, 2019
	$	$
Interest income	1,144	1,147
Foreign exchange gains (losses)	129	(83)
Accretion on decommissioning liability (note 9)	(149)	(219)
Interest on lease liability (note 8)	(11)	(15)
	1,113	830

16. EXPENSES BY NATURE

In the Company's Statement of Income and Comprehensive Income, items are primarily disclosed by nature except for employee compensation which is included in production expense, general and administrative expenses and stock-based compensation expense as follows:

	December 31, 2020	December 31, 2019
	$	$
Production	597	770
General and administrative	1,320	1,248
Stock-based compensation	1,477	337
	3,394	2,355

17. SUPPLEMENTAL CASH FLOW INFORMATION

	December 31, 2020	December 31, 2019
	$	$
Change in non-cash operating working capital:		
Accounts receivable	(1,988)	693
Inventories	(269)	-
Prepaids and deposits	54	(12)
Accounts payable and accrued liabilities	1,276	(26)
Deferred share units liability	(295)	-
	(1,222)	655
Change in non-cash investing working capital:		
Accounts receivable	-	522
Accounts payable and accrued liabilities	1,451	(811)
	1,451	(289)
Interest received	947	1,339

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

a) Commodity price risk

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

The Company unwound and monetized various financial derivative commodity contracts for cash proceeds of $1,589 thousand in December 2020.

The Company has the following outstanding financial derivative commodity contracts as at December 31, 2020:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT (1)	Fixed	Jan 1- Jan 31, 2021	7,500 mmbtu	Cdn$6.62/mmbtu
Natural Gas	AGT	Fixed	Feb 1- Feb 28, 2021	5,000 mmbtu	Cdn$6.50/mmbtu
Natural Gas	AGT	Fixed	Mar 1- Mar 31, 2021	5,000 mmbtu	Cdn$4.61/mmbtu

(1) AGT = Algonquin city-gates

As security for certain financial derivative commodity contracts, the counterparty has the authority to hold Headwater funds in the amount of US$6.5 million. As at December 31, 2020, US$1.16 million was held as cash collateral which was recorded as restricted cash in the Statement of Financial Position.

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

The following financial derivatives gains (losses) are reflected in the Statement of Income and Comprehensive Income:

	December 31, 2020	December 31, 2019
	$	$
Financial derivatives gains (losses):		
- realized gains	5,515	3,691
- unrealized financial derivative gains (losses)	(1,407)	485
Financial derivatives gains	4,108	4,176

The fair value of the financial derivative receivable of $74 thousand as at December 31, 2020 is based on estimated future natural gas prices as of that date. The fair values of these financial derivative commodity contracts are sensitive to changes in the natural gas reference prices. Holding other assumptions constant, if AGT prices increased (decreased) by 10%, the fair value of the financial derivative receivable would (decrease) increase by $309 thousand.

The Company has accounted for its physical delivery sales contracts, which were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with its expected purchase, sale or usage requirements as executory contracts. As such, these contracts are not considered to be derivative financial instruments and have not been recorded at fair value in the Statement of Financial Position. Settlements on these physical delivery sales contracts are recognized in sales in the period the product is delivered to the sales point.

ii) Foreign currency risk

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

The Company's financial derivative commodity contracts mentioned under i) above are fixed in Canadian dollars to mitigate some of Headwater's foreign currency risk. As at December 31, 2020, there are no foreign exchange risk management contracts outstanding.

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

(thousands of U.S. dollars)	December 31, 2020	December 31, 2019
	$	$
Cash	7	509
Accounts receivable	1,031	3,166
Financial instruments in U.S. dollars	1,038	3,675

The Company's financial instruments denominated in U.S. dollars are converted to Canadian dollars using the foreign exchange rate on the Statement of Financial Position date. Had the Canadian dollar weakened to the U.S. dollar by 5% on December 31, 2020, the Company's net income before taxes for the year ended December 31, 2020 would be higher by $66 thousand. Had the Canadian dollar strengthened to the U.S. dollar by 5% on December 31, 2020, the Company's net income before taxes for the year ended December 31, 2020 would be lower by $66 thousand.

Fair Value Measurement

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

- Level 1 – Values are used based on unadjusted quoted prices available in active markets for identical assets and liabilities as of the reporting date.

- Level 2 – Values are based on inputs, including forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace. Prices in Level 2 are either directly or indirectly observable as of the reporting date.

- Level 3 – Values are based on prices or valuation techniques that are not based on observable market data.

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

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

iii) Credit risk

As at December 31, 2020, the carrying amount of cash and cash equivalents, restricted cash, accounts receivable and deposits represent the Company's maximum credit exposure. The Company's cash and cash equivalents are held on deposit with Canadian chartered banks.

Headwater's receivables from its crude oil and natural gas sales are subject to normal credit risk. During the year ended December 31, 2020, the Company sold its crude oil and natural gas production to two counterparties. Headwater mitigates the risk of loss by ensuring its counterparties are investment grade as ranked by reputable credit agencies. Headwater historically has not experienced any collection issues. Payment of revenues from both counterparties occurs on the 25th day following the month of sale. As a result, the Company's production revenues are current.

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

At December 31, 2020, 100% of the Company's accounts receivables were outstanding for less than 30 days. The average expected credit loss on the Company's accounts receivable is 0% as at December 31, 2020. Trade receivables generally have a 30-day term and have all been collected subsequent to year-end. As at December 31, 2020, the Company's receivables consisted of $4,980 thousand (December 31, 2019 - $2,632 thousand) from crude oil and natural gas marketers, $237 thousand (December 31, 2019 - $276 thousand) from its joint venture partner, $258 thousand (December 31, 2019 - $99 thousand) related to accrued interest and GST input tax credits.

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company manages liquidity risk through its working capital surplus and an actively managed operating and capital expenditure budgeting process. As at December 31, 2020, the Company was holding cash and cash equivalents of $76,772 thousand.

The following table details the contractual maturities of the Company's liabilities as at December 31, 2020:

	Within 1 year	1 to 5 years
	$	$
Accounts payable and accrued liabilities	4,105	-
DSU liability	91	-
Lease liability	138	298
Total	4,334	298

b) Management of capital

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

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

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

Pursuant to the Acquisition, Headwater entered into a development agreement with Cenovus on the Closing Date, under which the Company committed to spend $100 million in capital expenditures ("Expenditures") on the Acquired Assets by December 31, 2022 unless otherwise extended by Cenovus. The Company expects to fund these Expenditures through its working capital surplus and cash flow from operating activities.

The Company has not paid or declared any dividends.

19. RELATED PARTY TRANSACTIONS

The following table presents the remuneration accrued to key management personnel and the Board of Directors through the year:

	December 31, 2020	December 31, 2019
	$	$
Wages and benefits – key management personnel	2,304	1,026
Directors' compensation	610	202
Stock-based compensation – directors & key management personnel	1,260	232
	4,174	1,460

Wages and benefits to key management personnel include salary, bonus, severance and benefits accrued during the year. Directors' compensation includes directors' fees accrued in general and administrative expenses as well as payments made under the DSU plan. DSUs were paid out pursuant to the Recapitalization Transaction and the reconstitution of the Board of Directors. Stock-based compensation includes non-cash expenses accrued under the Company's Old Option Plan, New Option Plan and DSU plans for both key management personnel and directors of the Company. As there was a change in management and Board of Directors through the year, the above table includes remuneration to both the former management and Board of Directors of Corridor and the new management and Board of Directors of Headwater.

Transactions with Cenovus

As at December 31, 2020, Cenovus owned 25.6% of the Company's basic common shares outstanding and two of its senior officers serve as directors of Headwater. In connection with the Acquisition, Headwater and Cenovus entered into a marketing agreement. Headwater considers the marketing agreement to be at market terms and in the ordinary course of business. The contract terminates on December 2, 2023. As at December 31, 2020, a receivable of $3.7 million was recorded from Cenovus for December heavy oil sales net of blending costs, certain transportation costs and royalties. Additionally,

Cenovus retained a gross overriding royalty on the Marten Hills Assets and the Company has a capital commitment under which Headwater is committed to spend $100 million in Expenditures on the Marten Hills Assets by December 31, 2022 pursuant to a development agreement.

20. COMMITMENTS

a) Commitments

As at December 31, 2020, the Company is committed to future payments under the following agreements:

	Total	2021	2022	2023	2024	2025	Thereafter
	$	$	$	$	$	$	$
Transportation [1]	110,766	7,419	9,038	10,691	10,905	11,982	60,731
Capital commitment [2]	100,000	-	100,000	-	-	-	-
Total [3]	210,766	7,419	109,038	10,691	10,905	11,982	60,731

(1) In connection with the completion of the Acquisition, Headwater assumed certain transportation contracts from Cenovus. Subsequent to the closing of the transaction, Headwater elected into the following obligations:
   a. 10- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
   b. 10- year financial commitment at $1,890 thousand per year adjusted for inflation.
   c. 10-year take-or-pay transportation agreement with a current minimum volume commitment of 1,250 boe/d increasing to 6,250 boe/d in year 3 and to 9,000 boe/d in year 6.

(2) In connection with the completion of the Acquisition, Headwater entered into a development agreement with Cenovus (the "Development Agreement") on the Closing Date, under which the Company committed to spend $100 million in Expenditures on the Acquired Assets by December 31, 2022 unless otherwise extended by Cenovus. The Company agreed that if it fails to satisfy the Expenditures prior to December 31, 2022, the Company will pay to Cenovus the balance of any remaining Expenditures and Headwater will have no further Expenditures under the Development Agreement.

(3) Excludes leases accounted for under IFRS 16. Refer to note 8.

b) Letter of credit

As at December 31, 2020, the Company had a standby letter of credit issued by a Canadian chartered bank in the amount of $350 thousand relating to a transportation arrangement. The standby letter of credit is recorded in restricted cash in the Statement of Financial Position.

21. SUBSEQUENT EVENTS

a) Stock option grant

Subsequent to December 31, 2020, Headwater granted 710 thousand stock options to new employees of the Company under the New Option Plan.

In addition, at the meeting of the Board of Directors held on March 10, 2021, the Directors approved a total grant of up to 2,300,000 stock options to Directors, management and employees under the New Option Plan.

b) Financial derivative commodity contracts and foreign exchange contract

Subsequent to December 31, 2020, Headwater entered into the following financial derivative contracts:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Heavy Oil	WCS differential [1]	Fixed	Oct 2021 - Dec 2021	2,000 bbls/d	US$13.16/bbl
Natural Gas	AGT	Fixed	Feb 2 – Feb 28, 2021	2,500 mmbtu/d	Cdn$9.19/mmbtu
Natural Gas	AGT	Fixed	April 2021	5,000 mmbtu/d	Cdn$3.88/mmbtu
Natural Gas	AGT differential	Fixed	Dec 2021 – Mar 2022	2,500 mmbtu/d	Cdn$4.16/mmbtu

(1) WCS differential = Western Canadian Select differential to West Texas Intermediate

Subsequent to December 31, 2020, Headwater entered into the following foreign exchange contract:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement date
Forward contract	CAD	US	1.2691	US$3 million	March 26, 2021