

Q1 2021 Management's Discussion and Analysis

The following management's discussion and analysis ("MD&A") as provided by the management of Headwater Exploration Inc. ("Headwater" or the "Company") is dated May 12, 2021 and should be read in conjunction with the unaudited interim condensed financial statements as at and for the three months ended March 31, 2021, and the MD&A and the audited financial statements and the notes thereto for the year ended December 31, 2020, copies of which are available through the System for Electronic Document Analysis and Retrieval ("SEDAR") at www.sedar.com. The unaudited interim condensed financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and in accordance with IAS 34 *Interim Financial Reporting*. All dollar amounts are referenced in Canadian dollars unless otherwise stated.

Description of the Company

Headwater is a Canadian junior resource company engaged in the exploration for and development and production of petroleum and natural gas in Canada. Headwater currently has heavy oil production in the Clearwater formation in the Marten Hills area of Alberta and natural gas production in the McCully field near Sussex, New Brunswick.

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

HIGHLIGHTS FOR THREE MONTHS ENDED MARCH 31, 2021

- Generated average production of 4,805 boe/d representing an increase of 192% over the fourth quarter of 2020.
- Achieved adjusted funds flow from operations ⁽¹⁾ of \$14.5 million (\$0.07 per share basic), representing an increase of 201% over the fourth quarter of 2020. Cash flows from operating activities were \$12.8 million in the first quarter of 2021.
- Achieved an operating netback of \$35.46/boe and an adjusted funds flow netback of \$33.75/boe.
- Achieved adjusted net income ⁽¹⁾ of \$6.4 million (\$0.03 per share basic). The Company's net loss was \$12.8 million in the first quarter of 2021 inclusive of the remeasurement loss on the warrant liability of \$19.2 million.
- Successfully executed a \$37.3 million exploration and development capital program in the Marten Hills area inclusive of drilling 12, 8-leg multi-lateral producing wells, 5 horizontal injection wells, 2 source water wells and 1 stratigraphic test well.
- Executed an agreement with another area operator to construct a joint gas processing facility. The facility is currently under construction and is on track to be commissioned by early July 2021. This facility will allow Headwater to achieve gas conservation from production in the core area of Marten Hills.
- The Company's McCully asset performed strongly through the quarter contributing \$5.0 million in operating cash flow ⁽¹⁾. Consistent with prior years and to optimize cash flow, Headwater shut-in production May 1, 2021 to await next winter's premium pricing season. Approximately 40% of next winter's volumes are hedged at an average price of US\$7.39/mmbtu.

- As at March 31, 2021, Headwater had adjusted working capital ⁽¹⁾ of \$58.4 million and no outstanding debt. The Company's working capital, inclusive of financial derivatives and the warrant liability, was \$28.7 million as at March 31, 2021.

(1) Non-IFRS measure. See "Non-IFRS Financial Measures" advisory.

Results of Operations

Operating netback

The components of Headwater's operating netback for the three months ended March 31, 2021, for both of its Marten Hills assets and McCully assets are summarized below.

Marten Hills Assets

	Three months ended March 31,		Percent Change
	2021	2020	
	(\$/boe)		
Sales, net of blending ⁽¹⁾	55.72	-	100
Royalties	(7.08)	-	100
Transportation expense	(8.60)	-	100
Production expense	(6.13)	-	100
Operating netback ⁽²⁾	<u>33.91</u>	-	100
Heavy oil sales (bbls/d) ^{(3) (4)}	3,347	-	100
Heavy oil production (bbls/d) ⁽³⁾	3,385	-	100

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

(2) Operating metric. See "Operating Metrics" advisory. Netbacks are calculated using average unblended sales volumes.

(3) The Company's heavy oil sales and production volumes differ due to changes in inventory.

(4) Presented as unblended sales excluding the impact of purchased condensate.

McCully Assets

	Three months ended March 31,		Percent Change
	2021	2020	
	(\$/boe)		
Sales	49.56	17.06	191
Royalties	(1.74)	(0.42)	314
Production expense	(4.45)	(4.78)	(7)
Realized gain (loss) on financial derivatives	(4.32)	29.09	(115)
Operating netback	<u>39.05</u>	<u>40.95</u>	(5)
Natural gas and NGL production (boe/d)	1,420	1,487	(5)

Total Assets

	Three months ended March 31,		Percent Change
	2021	2020	
	(\$/boe)		
Sales, net of blending	53.89	17.06	216
Royalties	(5.49)	(0.42)	1207
Transportation expense	(6.04)	-	100
Production expense	(5.62)	(4.78)	18
Realized gain (loss) on financial derivatives	(1.28)	29.09	(104)
Operating netback	<u>35.46</u>	<u>40.95</u>	(13)
Average daily sales (boe/d)	4,768	1,487	221
Average daily production (boe/d)	4,805	1,487	223

Production and Pricing

	Three months ended March 31,		Percent Change
	2021	2020	
Average daily production			
Heavy oil (bbls/d)	3,385	-	100
Natural gas (mmcf/d)	8.5	8.9	(4)
Natural gas liquids (bbls/d)	5	7	(29)
Barrels of oil equivalent (boe/d)	4,805	1,487	223
Average daily sales ⁽¹⁾	4,768	1,487	221
Headwater average sales price ⁽²⁾			
Heavy oil (\$/bbl) ⁽³⁾	55.72	-	100
Natural gas (\$/mcf)	7.48	2.49	200
Natural gas liquids (\$/bbl)	66.55	57.90	15
Barrels of oil equivalent (\$/boe)	52.51	15.12	247
Average Benchmark Price			
WTI (US\$/bbl) ⁽⁴⁾	57.84	46.17	25
WCS differential to WTI (US\$/bbl)	(12.47)	(20.53)	(39)
WCS (Cdn\$/bbl) ⁽⁵⁾	57.43	34.12	68
Condensate at Edmonton (\$Cdn/bbl)	72.92	60.39	21
AGT (US\$/mmbtu) ⁽⁶⁾	5.56	2.22	150
NYMEX Henry Hub (US\$/mmbtu)	2.69	1.95	38
Exchange rate (US\$/Cdn\$)	0.79	0.74	7

(1) Includes sales of unblended heavy crude oil, natural gas and natural gas liquids. The Company's heavy oil sales volumes and production volumes differ due to changes in inventory.

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

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

(4) WTI = West Texas Intermediate

(5) WCS = Western Canadian Select

(6) AGT = Algonquin city-gates

Sales

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Heavy oil, net of blending	16,785	-	100
Natural gas	5,718	2,009	185
Natural gas liquids	31	37	(16)
Total product sales, net of blending	22,534	2,046	1001
Gathering, processing and transportation revenue	588	262	124
Total sales, net of blending	23,122	2,308	902

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

Headwater's sales volumes averaged 3,347 bbls/d and its heavy oil sales net of blending expense were \$16,785 thousand in the first quarter of 2021, attributable to revenue earned from its recently acquired Marten Hills assets. The Company's heavy oil realized price for the three months ended March 31, 2021 was \$55.72/bbl, reflecting a discount to WCS of \$1.71/bbl.

The Company sells its natural gas production daily from the McCully field in New Brunswick. The transaction price is based on the AGT daily benchmark price adjusted for the delivery location and heat content. In recent years, the AGT market has been characterized by excess demand during the winter season resulting in significant premiums in the sales price for natural gas during the winter season as compared to prices during other periods of the year. Consistent with prior years, the Company shut-in production for the upcoming summer season effective May 1, 2021.

During the three months ended March 31, 2021, natural gas production averaged 8.5 mmcf/d consistent with the corresponding period of 2020 which averaged 8.9 mmcf/d.

Natural gas sales for the three months ended March 31, 2021 increased to \$5,718 thousand from \$2,009 thousand in the corresponding period of 2020, due primarily to a 200% increase in Headwater's average realized natural gas sales price to \$7.48/mcf from \$2.49/mcf. The increase in Headwater's average realized natural gas sales price was consistent with the increase in the AGT benchmark price over the period and was due to a surge in cold weather from the polar vortex experienced in late January into February, driving up natural gas demand in the Northeastern United States.

Headwater owns the midstream facilities which process and transport gas from the McCully field to the Maritimes & Northeast Pipeline ("M&NP"). Gathering, processing and transportation revenue primarily relates to income earned on third party gas flowing through these facilities. This revenue will vary quarter over quarter depending on third party volumes processed.

Financial Derivatives Gains (Losses)

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Realized financial derivative gains (losses)	(551)	3,937	(114)
Unrealized financial derivative losses	(254)	(1,481)	(83)
Financial derivative gains (losses)	<u>(805)</u>	<u>2,456</u>	(133)
Per boe (\$)	1.87	18.15	(90)

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

The realized financial derivative losses represent the natural gas contracts settled during the three months ended March 31, 2021. Natural gas commodity contracts are referenced to the AGT price and the associated realized gains and losses fluctuate based on changes in the AGT price. A realized financial derivative loss was recorded during the three months ended March 31, 2021 of \$551 thousand compared to a realized gain of \$3,937 thousand for the three months ended March 31, 2020. The Company recognized losses on its natural gas contracts in 2021 as the commodity contracts to fix the AGT price were lower when compared to the AGT settlement price in the period. The below average temperatures from the polar vortex in February 2021 caused increased natural gas demand driving up actual realized pricing above Headwater's fixed contract pricing.

As of March 31, 2021, the fair value of Headwater's outstanding financial derivative contracts is an unrealized liability of \$180 thousand as reflected in the unaudited interim condensed financial statements. The fair value or mark to market value of these contracts is based upon the estimated amount that would have been payable as at March 31, 2021, had the contracts been monetized or terminated. Subsequent changes in the fair value of the contracts are recognized in each reporting period and could be materially different than what is recorded as at March 31, 2021.

As at March 31, 2021, Headwater has the following financial derivative commodity contracts outstanding:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT	Fixed	Apr 1- Apr 30, 2021	5,000 mmbtu	Cdn\$3.88/mmbtu
Natural Gas	AGT Basis ⁽¹⁾	Differential	Dec 1- Mar 31, 2022	2,500 mmbtu	Cdn\$4.16/mmbtu
Crude Oil	WCS Basis ⁽²⁾	Differential	Oct 1- Dec 31, 2021	2,000 bbls	US\$13.16/bbl

(1) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn\$4.16/mmbtu

(2) Headwater pays on WCS while counterparty pays on WTI less US\$13.16/bbl

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

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

As at March 31, 2021, Headwater has the following financial derivative foreign exchange contract outstanding:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	US	1.2619	US\$5,000,000	Apr 26- Apr 30, 2021

Royalty Expense

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Heavy oil	2,133	-	100
Natural gas and natural gas liquids	222	57	289
Total royalty expense	<u>2,355</u>	<u>57</u>	4032
Percentage of total product sales, net of blending expense	10.5%	2.8%	275
Per boe (\$)	5.49	0.42	1207

Royalty expense consists of crown royalties payable to the Alberta and New Brunswick provincial governments and the gross overriding royalty ("GORR") payable to a subsidiary of Cenovus Energy Inc. ("Cenovus").

Headwater's average corporate royalty rate was 10.5% during the first quarter of 2021 compared to an average royalty rate of 2.8% in 2020, reflecting crown and GORR royalties incurred on the recently acquired Marten Hills assets.

Transportation Expense

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Transportation expense	2,590	-	100
Per boe (\$)	6.04	-	100

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

For the three months ended March 31, 2021, transportation expense increased to \$2,590 thousand as a result of transportation costs incurred related to the Company's recently acquired Marten Hills assets.

Production Expense

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Production expense	2,413	647	273
Per boe (\$)	5.62	4.78	18

Production expense in the three months ended March 31, 2021 was \$2,413 thousand compared to \$647 thousand in the corresponding period of 2020. The increase in production expense reflects production expense incurred related to the Company's recently acquired Marten Hills assets.

Production expense for Headwater's McCully assets during the three months ended March 31, 2021 was \$567 thousand compared to \$647 thousand in the corresponding period of 2020. The decrease in production expenses in McCully is attributed to cost savings initiatives including restructuring the Company's joint venture agreement which increased operating recoveries during the period.

Production expense per boe increased during the three months ended March 31, 2021 when compared to the corresponding period of the prior year due to the integration of the Marten Hills assets.

General and Administrative ("G&A") Expenses

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
G&A expenses	1,539	683	125
Overhead recoveries & capitalized G&A	(692)	-	100
Net G&A expenses	<u>847</u>	<u>683</u>	24
Per boe (\$)	1.97	5.05	(61)

The Company incurred gross G&A expenses of \$1,539 thousand during the three months ended March 31, 2021 compared to \$683 thousand in the corresponding period of 2020. Increased G&A costs before recoveries and capitalization were mainly the result of a larger workforce to accommodate Headwater's recently acquired Marten Hills assets and include increased employee related costs such as salaries and wages and software fees. Professional fees were also higher due to the growth experienced by the Company. The Company recognized \$692 thousand in overhead recoveries and capitalized G&A as a result of Headwater's significant capital expenditure program in the first quarter of 2021.

Interest Income and Other

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Interest income	204	358	(43)
Foreign exchange gains (losses)	(92)	198	(146)
Accretion	(50)	(53)	(6)
Interest on lease liability	(3)	(1)	200
Total interest income and other	<u>59</u>	<u>502</u>	(88)
Per boe (\$)	0.13	3.71	(96)

During the three months ended March 31, 2021, interest income and other was \$59 thousand compared to \$502 thousand in the corresponding period of 2020. The decrease for the three months ended March 31, 2021 was primarily due to foreign exchange losses of \$92 thousand in 2021 compared to foreign exchange gains of \$198 thousand in 2020 and a decrease in interest income. Realized foreign exchange gains and losses will vary depending on the fluctuation in the exchange rate between the timing of sales incurred which are denominated in US dollars and the timing of the settlement of the underlying receivable. Interest income decreased 43% due a lower average interest rate earned in 2021 when compared to 2020. The Bank of Canada dropped its overnight interest rate by 150 basis points from 1.75% to 0.25% in March 2020 as a response to economic uncertainty due to the COVID-19 pandemic.

Remeasurement Loss on Warrant Liability

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Remeasurement loss on warrant liability	19,195	-	100
Per boe (\$)	44.73	-	100

The Company issued 15 million warrants (the "Cenovus Warrants") to a subsidiary of Cenovus on December 2, 2020 which have an exercise price of \$2.00 and expire in December 2023.

During the three months ended March 31, 2021, the Company recognized a remeasurement loss on the warrant liability of \$19,195 thousand associated with the Cenovus Warrants.

The Cenovus Warrants are revalued every reporting period using a Monte Carlo simulation pricing model. The Company recognized a remeasurement loss of \$19,195 thousand as a result of the increase in the Company's closing common share price to \$3.91 on March 31, 2021 from \$2.39 on December 31, 2020.

As at March 31, 2021, all 15 million Cenovus Warrants remained outstanding. Headwater has the right, after twelve months have elapsed from December 2, 2020, and provided the 20-day volume weighted average share price of the Company's common shares exceeds the exercise price of the Cenovus Warrants, to require the holder to exercise all or a portion of the then-outstanding Cenovus Warrants. The Cenovus Warrants issued were classified as a financial liability as a result of a cashless exercise provision and are therefore carried at fair value through profit or loss. In no event will the Company be required to settle the Cenovus Warrants through a cash payment.

Stock-based Compensation

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Stock options	840	(30)	(2900)
Deferred share units	58	11	427
Capitalized stock-based compensation	(378)	-	100
Stock-based compensation expense (recovery)	<u>520</u>	<u>(19)</u>	(2837)
Per boe (\$)	1.21	(0.14)	(964)

Stock-based compensation with respect to stock options was higher when compared to the same period in the prior year as a result of the 7.9 million stock options granted during 2020 and the 3.0 million stock options granted during the first quarter of 2021. The stock options granted during the three months ended March 31, 2021 had a weighted average fair value of \$1.52 per stock option, estimated using the Black Scholes option pricing model. Stock-based compensation is recorded over a three-year vesting period using graded amortization resulting in a higher proportion of expense being recognized earlier in the vesting term. The Company capitalized \$378 thousand of stock-based compensation expense during the quarter as a result of Headwater's significant capital expenditure program.

Stock-based compensation relating to deferred share units ("DSUs") is due to the change in fair value of the DSUs over the period resulting from a corresponding change in the Company's share price. The DSU liability as at March 31, 2021 of \$149 thousand is based on a fair value of \$3.91 per DSU which is the Company's closing share price on March 31, 2021 (December 31, 2020 - \$2.39 per DSU).

Stock Option Plans

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 Toronto Stock Exchange ("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 New Option Plan was approved by the Company's shareholders at the Company's annual and special meeting of shareholders held on June 15, 2020.

As at March 31, 2021, there were 1,205,835 stock options outstanding under the Old Option Plan and 9,670,000 stock options outstanding under the New Option Plan.

Depletion & Depreciation

	Three months ended March 31,		<u>Percent Change</u>
	<u>2021</u>	<u>2020</u>	
	<i>(thousands of dollars)</i>		
Depletion	7,182	2,433	195
Depreciation	68	72	(6)
Depletion & depreciation	<u>7,250</u>	<u>2,505</u>	189
Depletion – Per boe (\$)	16.74	17.98	(7)
Depreciation – Per boe (\$)	0.16	0.54	(70)
Per boe (\$)	16.90	18.52	(9)

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

Depletion for the three months ended March 31, 2021 was \$7,182 thousand compared to \$2,433 thousand recorded in the corresponding period of 2020. This increase is primarily a result of depletion of \$5,085 thousand recorded for the Company's recently acquired Marten Hills assets.

Depletion per boe decreased during the three months ended March 31, 2021 when compared to the corresponding period of 2020, primarily due to the Marten Hills assets acquired at a lower cost per boe. The depletion rate in respect to the Company's McCully assets in the first quarter of 2021 was consistent with the comparable period of 2020, as the increase to the depletion base from the \$15.1 million impairment reversal recognized in the fourth quarter of 2020 was offset by the change in basis of reserves from proved reserves to proved plus probable reserves.

Impairment Assessment

At March 31, 2021, there were no indicators of impairment or reversal of impairment identified for either of the Company's Alberta and New Brunswick CGUs. As such, an impairment test was not performed.

Decommissioning Liabilities

As at March 31, 2021, the decommissioning liabilities of the Company were \$18,092 thousand. The Company recorded an increase of \$1,374 thousand in the obligation from the decommissioning liability of \$16,718 thousand as at December 31, 2020. This increase of \$1,374 thousand is due to additions of \$3,724 thousand as a result of the Company's capital expenditure program and accretion expense of \$50 thousand partially offset by a downward change in estimate of \$2,400 thousand. The change in estimate is a result of an increase to the risk-free rate from 1.2% at December 31, 2020 to 2.0% at March 31, 2021, partially offset by an increase to the inflation rate from 1.5% at December 31, 2020 to 1.7% at March 31, 2021. The

total undiscounted uninflated amount of estimated cash flows required to settle these obligations is \$19,358 thousand (December 31, 2020 - \$15,456 thousand).

Deferred Income Taxes

At March 31, 2021, the Company had approximately \$286 million of tax pools available to be applied against future taxable income. The federal tax pools are estimated as follows:

<i>(\$ thousands)</i>	Estimated balance at March 31, 2021
Canadian oil and gas property expense	72,783
Canadian development expense	40,639
Canadian exploration expense	96,841
Undepreciated capital cost	43,846
Non-capital losses	26,028
Other	6,054
Total	286,191

Adjusted Funds Flow from Operations, Net Loss and Adjusted Net Income (Loss)

The Company's adjusted funds flow from operations and net income generating capability are a direct result of production and commodity prices. For the three months ended March 31, 2021, Headwater generated adjusted net income of \$6,402 thousand compared to an adjusted net loss of \$6,810 thousand for the three months ended March 31, 2020 primarily due to operating cash flow from the recently acquired Marten Hills assets of \$10,217 thousand. Higher depletion and depreciation expense for the three months ended March 31, 2021 was more than offset by non-recurring charges incurred during the three months ended March 31, 2020, including transaction costs of \$4,382 thousand and exploration and evaluation expense of \$3,821 thousand.

Adjusted funds flow from operations increased to \$14,479 thousand for the three months ended March 31, 2021 from \$5,413 thousand for the three months ended March 31, 2020, primarily due to operating cash flow generated from the Company's recently acquired Marten Hills assets.

Refer to "Non-IFRS Financial Measures" for a reconciliation between IFRS and Non-IFRS measures.

The following table summarizes the operating netback, adjusted funds flow netback and adjusted net income (loss) on a barrel of oil equivalent basis:

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(\$/boe)</i>		
Sales, net of blending ⁽¹⁾	53.89	17.06	216
Realized gains (losses) on financial derivatives	(1.28)	29.09	(104)
Royalties	(5.49)	(0.42)	1207
Net sales	47.12	45.73	3
Transportation ⁽¹⁾	(6.04)	-	100
Production expense	(5.62)	(4.78)	18
Operating netback ⁽²⁾	35.46	40.95	(13)
General and administrative expenses	(1.97)	(5.05)	(61)
Interest income and other ⁽³⁾	0.26	4.10	(94)

Adjusted funds flow netback ⁽²⁾	33.75	40.00	(16)
Transaction costs	-	(32.39)	(100)
Remeasurement loss on warrant liability	(44.73)	-	100
Unrealized losses on financial derivatives	(0.59)	(10.94)	(95)
Stock-based compensation (expense) recovery	(1.21)	0.14	(964)
Depletion and depreciation	(16.90)	(18.52)	(9)
Accretion and other expense	(0.13)	(0.39)	(67)
Exploration and evaluation expense	-	(28.24)	(100)
Net loss	<u>(29.81)</u>	<u>(50.34)</u>	(41)
Remeasurement loss on warrant liability	44.73	-	100
Adjusted net income (loss) ⁽²⁾	<u>14.92</u>	<u>(50.34)</u>	(130)

- (1) Heavy oil sales are netted with blending expense to compare the realized price to benchmark pricing. In the interim condensed financial statements, blending is recorded as blending and transportation expense.
- (2) Operating metric. See "Operating Metrics" advisory. Netbacks are calculated using average sales volumes.
- (3) Excludes accretion on decommissioning liabilities and interest on lease liability.

Capital Expenditures

In the first quarter of 2021 the Company invested a total of \$37.3 million of exploration and development capital. The expenditures for the three months ended March 31, 2021 are detailed below:

	Three months ended March 31,		Percent Change
	2021	2020	
	<i>(thousands of dollars)</i>		
Lease acquisition and retention	100	-	100
Geological and geophysical	177	-	100
Drilling and completions	21,988	-	100
Equipping and facilities	15,006	50	N/A
Corporate	1	20	(95)
Total exploration and development capital expenditures	<u>37,272</u>	<u>70</u>	N/A

During the first quarter of 2021, Headwater drilled a total of 12 (12.0 net) crude oil wells (8-leg multi-laterals), 5 (5.0 net) single, dual and quad leg crude oil wells to be converted into injection wells, 2 (2.0 net) Grand Rapids source wells and 1 (1.0 net stratigraphic test well) with a 100% success rate.

During the three months ended March 31, 2021, the Company invested a total of \$37.3 million on capital expenditures including \$22.0 million on drilling and completions, \$15.0 million on equipping and facilities and \$0.3 million on geological and geophysical and lease acquisition costs. During the first quarter of 2021, Headwater executed an agreement with another area operator to construct a joint gas processing facility. The facility is currently under construction and is expected to be commissioned by early July 2021. This facility will allow Headwater to achieve gas conservation from production in the core area of Marten Hills.

Guidance

On May 12, 2021, the board of directors approved an increase in the 2021 production and capital expenditure guidance. Headwater expects to fund these expenditures through existing working capital and forecasted cash flows from operations.

The following table summarizes Headwater's revised 2021 guidance and the previously released guidance on March 10, 2021.

	Previous 2021 Guidance	Revised 2021 Guidance
Average Daily Production		
Annual average daily production (boe/d) ⁽¹⁾	6,500 - 7,000	7,000 – 7,250
Fourth quarter 2021 daily production (boe/d) ⁽¹⁾	8,000 - 8,500	9,000 – 9,500
Pricing		
Crude oil - WTI (\$US/bbl)	62.65	62.00
Crude oil - WCS (\$Cdn/bbl)	63.75	61.75
Natural gas - AGT (\$US/mmbtu) ⁽²⁾	4.36	4.56
Exchange rate (\$US/\$Cdn)	0.79	0.81
Financial Summary (\$millions)		
Capital expenditures	90 – 95	105 - 110
Estimated exit adjusted working capital ⁽³⁾	80	60

(1) See "Barrels of Oil Equivalent".

(2) The AGT price is the average for the winter producing months in the McCully field which include January – April 2021 and November – December 2021.

(3) Non-IFRS measure. See "Non-IFRS Financial Measures" advisory.

2020 Marten Hills Acquisition

On November 8, 2020, the Company entered into a purchase and sale agreement with Cenovus Energy Inc. ("Cenovus") to acquire Cenovus' Marten Hills assets. The acquisition was completed on December 2, 2020 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 attributed to the Cenovus Warrants. The Cenovus Warrants have a three-year term and an exercise price of \$2.00 per common share.

The acquired Marten Hills assets include 100% working interest in Marten Hills heavy oil properties (average 18 - 22° API) and 270 net sections of Clearwater rights. Cenovus retained a GORR on the Marten Hills assets. In connection with the completion of the acquisition, Headwater entered into a development agreement with Cenovus, under which the Company committed to spend \$100 million in expenditures on the Marten Hills assets by December 31, 2022 unless otherwise extended by Cenovus. The Company also assumed certain transportation commitments from Cenovus. Refer to heading "Contractual Obligations and Commitments" for additional information.

Drilling Activity

The following table summarizes the Company's drilling results:

	Three months ended March 31,			
	2021		2020	
	Gross	Net	Gross	Net
Crude oil	17	17.0	-	-
Natural gas	-	-	-	-
Injection	-	-	-	-
Source/stratigraphic test	3	3.0	-	-
Dry and abandoned	-	-	-	-
Total	20	20.0	-	-
Success	100%	100%	N/A	N/A

Headwater drilled 5 of the crude oil wells for future water injection with the expectation to convert the producing oil wells to injection wells in the fourth quarter of 2021.

Liquidity and Capital Resources

Headwater's liquidity depends on the Company's cash flows from operations, supplemented as necessary by equity and debt financings. At March 31, 2021, the Company had cash and cash equivalents of \$81.6 million, adjusted working capital of \$58.4 million and no outstanding debt. The Company expects to have adequate liquidity to fund the 2021 capital expenditure budget of \$105-\$110 million and contractual obligations in the near term through existing working capital and forecasted cash flows from operations. Headwater anticipates that it will make use of debt or equity financings for any substantial expansion in its capital program or to finance any significant acquisitions.

Contractual Obligations and Commitments

The following table details the contractual maturities of the Company's financial liabilities as at March 31, 2021:

	Within 1 year	1 to 5 years
	\$	\$
Accounts payable and accrued liabilities	37,828	-
Financial derivatives liability	180	-
DSU liability	149	-
Lease liability	140	263
Total	38,297	263

As at March 31, 2021, the Company is committed to future payments under the following agreements:

	Total	2021	2022	2023	2024	2025	Thereafter
	\$	\$	\$	\$	\$	\$	\$
Transportation ⁽¹⁾	108,930	5,583	9,038	10,691	10,905	11,982	60,731
Capital commitment ⁽²⁾	62,940	-	62,500	440	-	-	-
Total ⁽³⁾	171,870	5,583	71,538	11,131	10,905	11,982	60,731

- (1) As at March 31, 2021, Headwater has the following transportation commitments:
- 10- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
 - 10- year financial commitment at \$1,890 thousand per year adjusted for inflation.
 - 10- year take-or-pay transportation agreement with a current minimum volume commitment of 1,250 boe/d increasing to 6,250 boe/d in year 3 and to 9,000 boe/d in year 6.
- (2) See discussion under "Related Parties". An additional capital commitment was executed in 2021 whereby Headwater has committed to drill one Clearwater exploratory well before March 2023; if Headwater does not drill the well, it must pay \$440 thousand to Cenovus.

(3) Excludes leases accounted for under IFRS 16.

Common Share Information

Share Capital

<i>(thousands)</i>	Three months ended	
	March 31,	
	2021	2020
Weighted average outstanding common shares ⁽¹⁾		
-Basic	195,322	105,436
-Diluted	195,322	105,436
Outstanding securities at March 31, 2021		
-Common shares		195,574
-Stock options – weighted average strike price of \$2.10		10,876
-Recapitalization Warrants – strike price \$0.92 ⁽²⁾		21,260
-Cenovus Warrants – strike price of \$2.00 ⁽³⁾		15,000

- (1) The Company uses the treasury stock method to determine the dilutive effect of stock options and warrants. Under this method, only "in-the-money" dilutive instruments impact the calculation of diluted income per common share. This method also assumes that the proceeds received from the exercise of all "in-the-money" dilutive instruments are used to repurchase shares at the average market price.
- (2) Issued on the Recapitalization Transaction (as defined below) as part of the non-brokered private placement. As at March 31, 2021, these Recapitalization Warrants are fully exercisable with a strike price of \$0.92.
- (3) Issued as partial consideration for the Marten Hills assets. As at March 31, 2021, these Cenovus Warrants are fully exercisable with a strike price of \$2.00.

Changes to share capital in 2021 were the following:

- 67 thousand stock options were exercised for 51 thousand common shares on a cashless basis. Contributed surplus related to the stock options exercised of \$26 thousand was transferred to capital stock.
- 417 thousand Recapitalization Warrants were exercised for 417 thousand common shares for cash proceeds of \$384 thousand. The associated fair value of the Recapitalization Warrants of \$147 thousand was transferred to capital stock.

Recapitalization Transaction

On March 4, 2020, the Company completed its previously announced 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 ("Recapitalization Warrant") of the Company. Each Recapitalization Warrant entitles the holder to purchase one common share at a price of \$0.92 per common share for a period of 4 years from the issuance date. Pursuant to the rules of the TSX, the non-brokered private placement was approved by shareholders of the Company at a special meeting of the shareholders held on March 4, 2020. As at March 31, 2021, the Recapitalization Warrants are fully vested and exercisable.
- Concurrently with the closing of the non-brokered private placement, the appointment of a new management team and reconstitution of the board of directors was completed.
- A brokered private placement of 32,608,696 subscription receipts ("Subscription Receipts") of the Company, which were sold 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.

- The Company also changed its name to Headwater Exploration Inc., which name change was also approved by shareholders of the Company at the special meeting of the shareholders held on March 4, 2020.
- In connection with the Recapitalization Transaction, the Company incurred \$4.4 million of transaction costs and \$1.9 million in share issue costs.

Total Market Capitalization

The Company's market capitalization at March 31, 2021 was approximately \$764.7 million.

<i>(thousands)</i>	March 31, 2021
Common shares outstanding	195,574
Share price ⁽¹⁾	\$ 3.91
Total market capitalization	\$764,694

(1) Represents the closing price on the TSX on March 31, 2021.

As at May 12, 2021 the Company had 195,590,999 common shares outstanding.

<i>(thousands)</i>	May 12, 2021
Outstanding securities at May 12, 2021	
-Common shares	195,591
-Stock options – weighted average strike price of \$2.10	10,859
-Recapitalization Warrants – strike price \$0.92 ⁽²⁾	21,260
-Cenovus Warrants– strike price of \$2.00 ⁽³⁾	15,000

Related Party Transactions

Transactions with Cenovus

As at March 31, 2021, Cenovus owned 25.6% of the Company's basic common shares outstanding and two of its senior officers serve as directors of Headwater. Headwater and Cenovus have entered into a marketing agreement that terminates on December 2, 2023. As at March 31, 2021, a receivable of \$9.6 million was recorded from Cenovus for March heavy oil sales net of the GORR. Cenovus retained a GORR 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. As at March 31, 2021, the remaining capital commitment is approximately \$63 million.

Summary of Quarterly Information

	Q1/21	Q4/20	Q3/20	Q2/20	Q1/20	Q4/19	Q3/19	Q2/19
Financial (thousands of dollars except share data)								
Sales, net of blending ⁽¹⁾	23,122	6,283	-	565	2,308	2,310	-	1,014
Cash flows provided by (used in) operating activities ⁽⁶⁾	12,783	(1,451)	(364)	863	1,182	(192)	(342)	1,675
Adjusted funds flow from (used in) operations ^{(2), (6)}	14,479	4,816	(837)	(610)	5,413	1,929	(1,427)	151
Per share - basic	0.07	0.03	(0.01)	-	0.05	0.02	(0.02)	-
- diluted	0.07	0.03	(0.01)	-	0.05	0.02	(0.02)	-
Net income (loss)	(12,793)	16,919	(1,723)	(1,679)	(6,810)	1,447	(1,318)	(274)
Per share - basic	(0.07)	0.10	(0.01)	(0.01)	(0.06)	0.02	(0.02)	-
- diluted	(0.07)	0.10	(0.01)	(0.01)	(0.06)	0.02	(0.02)	-
Adjusted net income (loss) ⁽²⁾	6,402	21,208	(1,723)	(1,679)	(6,810)	1,447	(1,318)	(274)
Per share - basic	0.03	0.13	(0.01)	(0.01)	(0.06)	0.02	(0.02)	-
- diluted	0.03	0.13	(0.01)	(0.01)	(0.06)	0.02	(0.02)	-
Capital expenditures	37,272	1,748	61	398	70	227	69	211
Acquisition	-	135,297	-	-	-	-	-	-
Adjusted working capital ⁽²⁾	58,367	80,759	112,667	113,569	114,200	63,141	61,388	62,937
Shareholders' equity	257,461	269,030	155,148	156,386	157,235	114,310	112,792	114,148
Weighted average shares (thousands)								
Basic	195,322	161,365	145,044	144,749	105,436	88,147	88,172	88,724
Diluted	195,322	168,600	145,044	144,749	105,436	88,542	88,172	88,724
Shares outstanding, end of period (thousands)								
Basic	195,574	195,106	145,044	145,044	144,327	88,147	88,147	88,301
Diluted ⁽⁸⁾	240,456	238,121	158,627	151,381	145,552	89,842	88,935	89,089
Operating (6:1 boe conversion)								
Average daily production								
Heavy oil (bbls/d)	3,385	979	-	-	-	-	-	-
Natural gas (mmcf/d)	8.5	4.0	-	2.4	8.9	3.5	-	2.4
Natural gas liquids (bbls/d)	5	3	-	-	7	2	-	3
Barrels of oil equivalent (boe/d) ⁽³⁾	4,805	1,646	-	396	1,487	586	-	401
Average daily sales ⁽⁹⁾	4,768	1,646	-	396	1,487	586	-	401
Average selling prices								
Heavy oil (\$/bbl)	55.72	45.05	-	-	-	-	-	-
Natural gas (\$/mcf)	7.48	5.37	-	2.27	2.49	6.80	-	4.16
Natural gas liquids (\$/bbl)	66.55	56.23	-	-	57.90	83.34	-	89.82
Barrels of oil equivalent (\$/boe) ⁽³⁾	52.51	39.90	-	13.63	15.12	40.92	-	25.49
Netbacks (\$/boe) ^{(5), (10)}								
Operating								
Sales, net of blending ^{(1), (4)}	53.89	41.50	-	15.67	17.06	42.84	-	27.75
Realized gain on financial derivatives	(1.28)	10.42	-	-	29.09	14.70	-	1.43
Royalties	(5.49)	(3.86)	-	(0.39)	(0.42)	(0.96)	-	(0.53)
Transportation ⁽¹⁾	(6.04)	(5.10)	-	-	-	-	-	-
Production expense	(5.62)	(7.92)	-	(14.79)	(4.78)	(12.19)	-	(16.64)
Operating netback (\$/boe)	35.46	35.04	-	0.49	40.95	44.39	-	12.01
General and administrative	(1.97)	(4.64)	-	(23.33)	(5.05)	(13.22)	-	(15.89)
Interest income and other ⁽⁷⁾	0.26	1.39	-	6.00	4.10	4.73	-	8.46
Decommissioning liabilities settled	-	-	-	-	-	(0.13)	-	(0.44)
Adjusted funds flow netback (\$/boe) ⁽⁶⁾	33.75	31.79	-	(16.84)	40.00	35.77	-	4.14

(1) Heavy oil sales are netted with blending expense to compare the realized price to benchmark. In the interim condensed financial statements, blending is recorded as blending and transportation expense.

(2) Non-IFRS measure. See "Non-IFRS Financial Measures" advisory.

(3) See barrels of oil equivalent under "Oil and Gas Measures".

(4) Excludes realized and unrealized gains (losses) on financial derivative contracts.

- (5) Operating metric. See "Operating Metrics" advisory.
- (6) Comparative period revised to reflect current period presentation. Decommissioning liabilities settled was previously not included in cash flows from operations, adjusted funds flow from operations or the adjusted funds flow netback calculation.
- (7) Excludes accretion on decommissioning liabilities and interest on the lease liability.
- (8) Includes in-the-money dilutive instruments as at March 31, 2021 which include 8.6 million stock options with a weighted average exercise price of \$1.44, 21.3 million Recapitalization Warrants with an exercise price of \$0.92 and 15 million Cenovus Warrants with an exercise price of \$2.00.
- (9) Includes sales of unblended heavy crude oil, natural gas and natural gas liquids. The Company's heavy oil sales volumes and production volumes differ due to changes in inventory.
- (10) Netbacks are calculated using average sales volumes.

During the three months ended March 31, 2021, Headwater generated adjusted net income of \$6,402 thousand due to operating cash flow from the recently acquired Marten Hills assets of \$10,217 thousand and operating cash flow from the Company's McCully assets of \$4,997 thousand partially offset by depletion and depreciation expense of \$7,250 thousand, general and administrative expenses of \$847 thousand and stock-based compensation expense of \$520 thousand. The remeasurement loss on the warrant liability of \$19,195 thousand contributed to the Company's net loss for the three months ended March 31, 2021 of \$12,793 thousand.

During the three months ended December 31, 2020, Headwater closed the Marten Hills acquisition for estimated total consideration of \$135.3 million comprised of \$32.8 million of cash, \$96.5 million of common shares valued using Headwater's closing share price on the closing date and \$6.0 million attributed to the Cenovus Warrants. The Marten Hills assets added \$4,400 thousand of heavy oil sales for the three months ended December 31, 2020. Additionally, the Company incurred \$2,948 thousand of transaction costs to complete the acquisition. Headwater generated net income of \$16,919 in the fourth quarter of 2020 primarily due to a property, plant and equipment impairment reversal of \$15,054 thousand related to the McCully CGU and a deferred income tax recovery of \$7,277 thousand.

During the three months ended March 31, 2020, Headwater completed the Recapitalization Transaction which included non-brokered and brokered private placements for aggregate gross proceeds of \$50 million. Headwater incurred a net loss of \$6,810 thousand for the quarter primarily due to transaction costs of \$4,382 thousand incurred pursuant to the Recapitalization Transaction, exploration and evaluation expense of \$3,821 thousand and lower natural gas sales attributed to a lower average realized natural gas sales price.

Headwater's natural gas sales are priced at AGT. In response to higher natural gas pricing in the winter season, since 2015, the Company has shut-in most of its producing natural gas wells in the McCully field in New Brunswick for a portion of the summer and fall period to time the start-up of production, and the associated recovery of flush volumes, with peak winter pricing to maximize cash flows from operations and to retain Headwater's reserves for production in future years.

Off-Balance Sheet Arrangements

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

Subsequent Events

Subsequent to March 31, 2021, Headwater entered into the following financial derivative commodity and foreign exchange contracts:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	NYMEX	Fixed	Dec 1- Mar 31, 2022	2,500 mmbtu	US\$3.11/mmbtu
Natural Gas	NYMEX	Fixed	Jan 1- Feb 28, 2022	2,500 mmbtu	US\$3.19/mmbtu
Natural Gas	AGT Basis	Differential	Jan 1- Feb 28, 2022	2,500 mmbtu	US\$6.00/mmbtu

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	US	1.2300	US\$5,000,000	May 25- May 28, 2021
Forward contract	CAD	US	WMR noon rate, May 2021 average ⁽¹⁾	US\$5,800,000	June 25, 2021

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

Non-IFRS Financial Measures

Throughout this MD&A, the Company uses the terms “operating cash flow”, “adjusted funds flow from operations”, “adjusted net income (loss)” and “adjusted working capital”. These terms do not have any standardized meaning as prescribed by IFRS and, therefore, may not be comparable with the calculation of similar measures presented by other issuers.

Operating cash flow is a measure of the company’s efficiency and its ability to fund future capital expenditures. Operating cash flow is calculated as sales plus realized gains or losses on financial derivatives, less royalties, blending and transportation expense and production expense, as follows:

	Three months ended March 31,	
	2021	2020
	<i>(thousands of dollars)</i>	
Sales	25,492	2,308
Realized gain (loss) on financial derivatives	(551)	3,937
Royalties	(2,355)	(57)
Blending and transportation	(4,959)	-
Production expense	(2,413)	(647)
Operating cash flow	<u>15,214</u>	<u>5,541</u>

Adjusted funds flow from operations is used by the Company to analyze operating performance. Adjusted funds flow from operations is defined as cash flows from operating activities before changes in non-cash working capital and transaction costs, as follows:

	Three months ended March 31,	
	2021	2020
	<i>(thousands of dollars)</i>	
Cash flow provided by operating activities	12,783	1,182
Changes in non-cash working capital	1,696	(151)
Transaction costs	-	4,382
Adjusted funds flow from operations	<u>14,479</u>	<u>5,413</u>

The Company utilizes adjusted net income (loss) as a measure of financial performance that is more comparable between periods. Adjusted net income (loss) is defined as net income (loss) before remeasurement loss on the warrant liability, as follows:

	Three months ended March 31,	
	2021	2020
	<i>(thousands of dollars)</i>	
Net loss	(12,793)	(6,810)
Remeasurement loss on warrant liability	19,195	-
Adjusted net income (loss)	<u>6,402</u>	<u>(6,810)</u>

Adjusted working capital is used by the Company to measure liquidity. Adjusted working capital is defined as working capital excluding the effects of the Company's financial derivatives and warrant liability, as follows:

	As at March 31, 2021	As at December 31, 2020
	<i>(thousands of dollars)</i>	
Working capital	28,687	70,528
Financial derivatives (receivable) payable	180	(74)
Warrant liability	29,500	10,305
Adjusted working capital	<u>58,367</u>	<u>80,759</u>

Operating Metrics

Operating metrics including operating netback, adjusted funds flow netback, adjusted net income and adjusted funds flow per share are metrics used in the oil and gas industry and are used by management to better analyze the Company's performance against prior periods on a comparable basis. These metrics have no equivalent IFRS measure and are therefore excluded from the discussion under "Non-IFRS Financial Measures". They also may not be comparable with the calculation of similar measures presented by other issuers.

Operating netback and adjusted funds flow netback are presented as operating cash flow and adjusted funds flow from operations on a per boe basis. Volumes used to calculate these netbacks include unblended heavy crude oil sales volumes in addition to sales volumes for natural gas and natural gas liquids. Adjusted funds flow per share is calculated as adjusted funds flow from operations divided by the number of weighted average basic or diluted shares outstanding during the period. See the table under the heading "Adjusted Funds Flow from Operations, Net Loss and Adjusted Net Income (Loss)" in this MD&A for additional details on how each of these metrics has been calculated.

Disclosure Controls and Procedures

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

Internal Controls over Financial Reporting

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

The Company confirms that there were no changes to Headwater's internal controls over financial reporting during the interim period from January 1, 2021 to March 31, 2021 that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

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

Critical Accounting Estimates

Use of estimates and judgments

The preparation of the Company's financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported 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 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, when required, is 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. A specific adjustment to the recoverable amount to account for the risk of climate change was not considered necessary for the impairment test completed in 2020, however, the recoverable amount was based on an estimated period of cash flows that indirectly reflects changing energy demands and the discount rate applied in the impairment test incorporated the cost of capital in the energy industry which indirectly reflected 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 March 31, 2021 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 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 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 Recapitalization 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.

Business Conditions and Risks

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

- Public health risks including relating to the COVID-19 pandemic may affect the Company's results, business, financial conditions or liquidity;
- Natural disasters, terrorist acts, civil unrest, pandemics and other disruptions and dislocations may affect the Company's results, business, financial conditions or liquidity;
- Weakness and volatility in the market conditions for the oil and natural gas industry may affect the value of the Company's reserves and restrict its cash flow and ability to access capital to fund the development of its properties;
- Current and any new regulations on hydraulic fracturing may lead to operational delays, increased costs and/or decreased production volumes, adversely affecting the Company's financial position;
- Various factors may adversely impact the marketability of oil and natural gas, affecting net production revenue, production volumes and development and exploration activities;
- The anticipated benefits of acquisitions may not be achieved and the Company may dispose of non-core assets for less than their carrying value on the financial statements as a result of weak market conditions;
- The Company's business may be adversely affected by recent political and social events and decisions made in Canada, the United States, Europe and elsewhere;
- Lack of capacity and/or regulatory constraints on gathering and processing facilities and pipeline systems may have a negative impact on the Company's ability to produce and sell its oil and natural gas;
- The Company competes with other oil and natural gas companies, some of which have greater financial and operational resources;
- The Company's ability to successfully implement new technologies into its operations in a timely and efficient manner will affect its ability to compete;
- Changes to the demand for oil and natural gas products and the rise of petroleum alternatives may negatively affect the Company's financial condition, results of operations and cash flow;
- Modification to current, or implementation of additional, regulations (including environmental regimes) or royalty regimes may reduce the demand for oil and natural gas, impact the Company's cash flows and/or increase the Company's costs and/or delay planned operations;
- Taxes on carbon emissions affect the demand for oil and natural gas, the Company's operating expenses and may impair the Company's ability to compete;
- Liability management programs enacted by regulators in the western provinces may prevent or interfere with the Company's ability to acquire properties or require a substantial cash deposit with the regulator;
- The Company may require additional financing, from time to time, to fund the acquisition, exploration and development of properties and its ability to obtain such financing in a timely fashion and on acceptable terms may be negatively impacted by the current economic and global market volatility;
- Changing investor sentiment towards the oil and natural gas industry may impact the Company's access to, and cost of capital;

- Oil and natural gas operations are subject to seasonal weather conditions and, if applicable to the Company's operations in the future, the Company may experience significant operational delays as a result;
- Regulatory water use restrictions and/or limited access to water or other fluids may impact the Company's future production volumes from any future waterflood of the Company;
- Credit risk related to non-payment for sales contracts or other counterparties;
- Foreign exchange risk as commodity sales are based on US dollar denominated benchmarks; and
- The risk of significant interruption or failure of the Company's information technology systems and related data and control systems or a significant breach that could adversely affect the Company's operations.

Additional risks and information on risk factors are included in the Annual Informational Form for the year ended December 31, 2020, dated March 10, 2021, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR at www.sedar.com.

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

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

Oil and Gas Metrics

Barrels of Oil Equivalent

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

Forward Looking Information

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

- business plans and strategies (including its production optimization and hedging strategies);

- the expected timing for commissioning of gas handling facility currently under construction and the expectation that the facility will allow Headwater to achieve gas conservation from production in the core area of Marten Hills;
- the expected timing for shutting in and resuming production from the Company's McCully assets;
- the expectation that Headwater could make use of additional equity or debt financings to fund future acquisitions;
- exploration and development plans of Headwater and the expectation Headwater can fund its \$63 million capital commitment and contractual obligations through existing working capital and adjusted funds flow from operations;
- revised 2021 guidance including annual average daily production, fourth quarter 2021 daily production, exit adjusted working capital and capital expenditures;
- expected timing of converting crude oil wells to injection wells for waterflood implementation;
- expected operations on the Company's current properties;
- Canadian – U.S. dollar exchange rate;
- expected natural gas sales prices and premiums;
- future revenue from financial hedges;
- the Company's tax pools and ability to use such tax assets in the future;
- the expectation that the Company has sufficient financial resources to fund its expected operations;
- the expectation that the Company has sufficient available funds to meet the Company's current and foreseeable contractual obligations;
- the expected effects of certain accounting changes;
- the expected sources to finance future acquisitions; and
- expected future decommissioning liabilities.

Statements relating to "reserves" are forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the reserves described, as applicable, exist in the quantities predicted or estimated and can profitably be produced in the future.

Undue reliance should not be placed on forward-looking statements, which are inherently uncertain, are based on estimates and assumptions, and are subject to known and unknown risks and uncertainties (both general and specific) that contribute to the possibility that the future events or circumstances contemplated by the forward-looking statements will not occur. There can be no assurance that the plans, intentions or expectations upon which forward-looking statements are based, will in fact be realized. Actual results will differ, and the difference may be material and adverse to the Company and its shareholders.

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

Any financial outlook or future oriented financial information in this MD&A as defined by applicable securities legislation, has been approved by management of the Company as of the date hereof. Readers are cautioned that any such future-oriented financial information contained herein should not be used for purposes other than those for which it is disclosed herein. Since forward-looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could

differ materially from those currently anticipated due to a number of factors and risks. These include, but are not limited to, risks associated with the oil and gas industry in general (e.g., operational risks in development, exploration and production; disruptions to the Canadian and global economy resulting from major public health events, including the COVID-19 pandemic, war, terrorist events, political upheavals and other similar events; events impacting the supply and demand for oil and gas including the COVID-19 pandemic and actions taken by the OPEC + group; delays or changes in plans with respect to exploration or development projects or capital expenditures relating to, among other things, restrictions on activities resulting from the COVID-19 pandemic; the uncertainty of reserve estimates; the uncertainty of estimates and projections relating to production, costs and expenses, and health, safety and environmental risks, commodity price and exchange rate fluctuations; changes in legislation affecting the oil and gas industry and uncertainties resulting from potential delays or changes in plans with respect to exploration or development projects or capital expenditures), trading of common shares, seasonality, disclosure controls and procedures and internal controls over financial reporting, competition, conflicts of interest, issuance of debt, title to properties, hedging, information systems, litigation, and aboriginal land and rights claims. Further information regarding these factors and additional factors may be found under the heading "Risk Factors" in the Annual Informational Form for the year ended December 31, 2020, dated March 10, 2021, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR at www.sedar.com. Readers are cautioned that the foregoing list of factors that may affect future results is not exhaustive.

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

Corporate Information

Board of Directors

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

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

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

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

PHILLIP KNOLL ⁽³⁾
Director Altagas Ltd.
Calgary, Alberta

KEVIN OLSON ^{(1) (3)}
President, Camber Capital Corp.
Calgary, Alberta

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

KAM SANDHAR ⁽¹⁾
Senior Vice-President, Conventional Cenovus Energy Inc.

SARAH WALTERS ⁽²⁾
Senior Vice-President, Corporate Services Cenovus Energy Inc.

(1) Audit Committee

(2) Corporate Governance and Sustainability Committee

(3) Reserves Committee

Website: www.headwaterexp.com

Officers

NEIL ROSZELL, P. Eng.
Executive Chairman & CEO

JASON JASKELA, P. Eng.
President and COO

ALI HORVATH, CPA, CA
Vice President Finance & CFO

TERRY DANKU, P. Eng.
Vice President Engineering

JON GRIMWOOD, P. Geo.
Vice President Exploration

SCOTT RIDEOUT
Vice President Land

BRAD CHRISTMAN
Vice President Production

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

Head Office

Suite 1200, 500 – 4th Avenue SW
Calgary, Alberta T2P 2V6
Tel: (587) 391-3680

Auditors

KPMG LLP
Calgary, Alberta

Independent Reservoir Consultants

GLJ Ltd.