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

(thousands)	March 31 2021 $	December 31 2020 $
ASSETS		
Current assets		
Cash and cash equivalents	81,643	76,772
Restricted cash (notes 13 & 15)	590	1,827
Accounts receivable (note 13)	13,210	5,475
Financial derivatives receivable (note 13)	-	74
Inventories	554	571
Prepaids and deposits	487	448
Total current assets	96,484	85,167
Exploration and evaluation assets (note 3)	27,379	27,101
Property, plant and equipment (note 4)	219,030	187,664
Right-of-use assets (note 5)	385	418
Other assets	335	335
Total assets	343,613	300,685
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 13)	37,828	4,105
Financial derivatives liability (note 13)	180	-
Deferred share units liability (note 9)	149	91
Current portion of lease liability (note 5)	140	138
Warrant liability (note 7)	29,500	10,305
Total current liabilities	67,797	14,639
Lease liability (note 5)	263	298
Decommissioning liability (note 6)	18,092	16,718
Total liabilities	86,152	31,655
Shareholders' Equity		
Capital stock (note 8)	387,950	387,393
Warrants (note 8)	7,512	7,659
Contributed surplus	12,473	11,659
Deficit	(150,474)	(137,681)
Total shareholders' equity	257,461	269,030
Total liabilities and shareholders' equity	343,613	300,685

Commitments (note 15)
Subsequent events (note 16)

See accompanying notes to the interim condensed financial statements

Approved on behalf of the Board of Directors:

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

(signed) "Neil Roszell"
Neil Roszell
Chairman

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

	Three months ended March 31,	
	2021	2020
(thousands, except per share data)	$	$
REVENUE		
Sales (note 10)	25,492	2,308
Royalties	(2,355)	(57)
Revenue, net of royalties	23,137	2,251
Gains (losses) on financial derivatives (note 13)	(805)	2,456
	22,332	4,707
EXPENSES		
Blending and transportation	4,959	-
Production	2,413	647
General and administrative	847	683
Transaction costs	-	4,382
Remeasurement loss on warrant liability (note 7)	19,195	-
Stock-based compensation expense (recovery) (note 9)	520	(19)
Depletion and depreciation (notes 4 & 5)	7,250	2,505
Exploration and evaluation expense (note 3)	-	3,821
	35,184	12,019
Interest income and other (note 11)	(59)	(502)
Loss before income taxes	(12,793)	(6,810)
Net loss and comprehensive loss	**(12,793)**	**(6,810)**
Net loss per share (note 8)		
Basic	(0.07)	(0.06)
Diluted	(0.07)	(0.06)

See accompanying notes to the interim condensed financial statements

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

	Three months ended March 31,	
Cash flow related to the following activities:	2021	2020
(thousands)	$	$
OPERATING		
Net loss	(12,793)	(6,810)
Items not involving cash:		
Unrealized losses on financial derivatives (note 13)	254	1,481
Remeasurement loss on warrant liability	19,195	-
Stock-based compensation expense (recovery)	520	(19)
Depletion and depreciation	7,250	2,505
Exploration and evaluation expense	-	3,821
Accretion and finance charges (note 11)	53	53
Change in non-cash operating working capital (note 12)	(1,696)	151
Cash flows provided by operating activities	12,783	1,182
FINANCING		
Issue of common shares, net of costs (note 8)	-	48,096
Payment of lease liability (note 5)	(36)	(37)
Proceeds from exercise of stock options & Warrants (note 8)	384	1,670
Cash flows provided by financing activities	348	49,729
INVESTING		
Capital expenditures – property, plant and equipment (note 4)	(36,994)	(65)
Capital expenditures – exploration and evaluation (note 3)	(278)	(5)
Change in restricted cash	1,237	-
Change in non-cash investing working capital (note 12)	27,775	(164)
Cash flows used in investing activities	(8,260)	(234)
Change in cash and cash equivalents	4,871	50,677
Cash and cash equivalents, beginning of period	76,772	60,957
Cash and cash equivalents, end of period	81,643	111,634
Cash and cash equivalents consist of:		
Cash	66,643	95,007
Cash equivalents	15,000	16,627
Cash and cash equivalents, end of period	81,643	111,634

See accompanying notes to the interim condensed financial statements

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

(thousands)	Notes	Capital stock $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' equity $
Balance at January 1, 2020		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Issued on Recapitalization Transaction	8	50,000	-	-	-	50,000
Allocation to Warrants	8	(7,680)	7,680	-	-	-
Issue costs	8	(1,905)	-	-	-	(1,905)
Exercise of stock options	8	2,581	-	(911)	-	1,670
Stock-based compensation	9	-	-	(30)	-	(30)
Net loss		-	-	-	(6,810)	(6,810)
Balance at March 31, 2020		**290,328**	**7,680**	**10,425**	**(151,198)**	**157,235**
Balance at January 1, 2021		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**
Exercise of stock options	8	26	-	(26)	-	-
Exercise of Warrants	8	531	(147)	-	-	384
Stock-based compensation	9	-	-	840	-	840
Net loss		-	-	-	(12,793)	(12,793)
Balance at March 31, 2021		**387,950**	**7,512**	**12,473**	**(150,474)**	**257,461**

See accompanying notes to the interim condensed financial statements

HEADWATER EXPLORATION INC.
Notes to the Interim Condensed Financial Statements
(unaudited)

As at and for the three months ended March 31, 2021 and 2020

(All tabular amounts in thousands, unless otherwise stated)

1. NATURE OF OPERATIONS

Headwater Exploration Inc. ("Headwater" or the "Company") is a Canadian junior resource company engaged in the exploration for and development and production of petroleum and natural gas in Canada. Headwater is a public company existing under the Alberta Business Corporations Act with common shares listed on the Toronto Stock Exchange ("TSX") under the symbol "HWX".

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

2. BASIS OF PREPARATION

Statement of compliance

These unaudited interim condensed financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), and in accordance with IAS 34 – *Interim Financial Reporting*. The unaudited interim condensed financial statements do not include all information required for annual financial statements and should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2020. These unaudited interim condensed financial statements have been prepared following the same accounting policies as the Company's audited financial statements for the year ended December 31, 2020.

These unaudited interim condensed financial statements were approved and authorized for issue by the Company's Board of Directors on May 12, 2021.

Basis of measurement, functional and presentation currency

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

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

Significant judgments and estimates

The timely preparation of the financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amount of assets, liabilities, income and expenses. Actual results may differ materially from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Significant judgments, estimates and assumptions made by management in these financial statements are outlined in note 2 of the December 31, 2020 annual financial statements. There have been no significant changes in the Company's judgments and estimates applied during the interim period ended March 31, 2021, relative to those described in the most recent annual financial statements as at and for the year ended December 31, 2020.

Since December 31, 2019, the outbreak of the COVID-19 pandemic has had a significantly negative impact on economic conditions around the world. This has resulted in significant volatility of commodity prices as well as increased economic uncertainty. Estimates and judgments made by management in the preparation of the interim condensed financial statements are increasingly difficult and subject to a higher degree of measurement uncertainty during this volatile period.

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

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

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

	March 31, 2021	December 31, 2020
	$	$
Balance, beginning of period	27,101	3,816
Acquired - property acquisition	-	26,637
Additions	278	469
Expensed	-	(3,821)
Balance, end of period	27,379	27,101

The Company concluded there are no indicators of impairment for its E&E assets at March 31, 2021.

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

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

	Oil and gas properties	Office and other assets	Total
Cost	$	$	$
Balance at December 31, 2019	324,448	2,684	327,132
Acquired - property acquisition	119,636	-	119,636
Additions	1,753	55	1,808
Changes in decommissioning liabilities	2,884	-	2,884
Balance at December 31, 2020	448,721	2,739	451,460
Additions	37,370	1	37,371
Changes in decommissioning liabilities	1,324	-	1,324
Balance at March 31, 2021	487,415	2,740	490,155
Accumulated depletion, depreciation and impairment			
Balance at December 31, 2019	270,946	2,068	273,014
Depletion or depreciation expense	5,733	83	5,816
Impairment reversal	(15,054)	-	(15,054)
Write-down of assets	20	-	20
Balance at December 31, 2020	261,645	2,151	263,796
Depletion or depreciation expense	7,309	20	7,329
Balance at March 31, 2021	268,954	2,171	271,125
Net book value at December 31, 2020	187,076	588	187,664
Net book value at March 31, 2021	218,461	569	219,030

As at March 31, 2021, the calculation of depletion includes estimated future development costs relating to the development of proved plus probable reserves of $49.6 million (December 31, 2020 – proved plus probable reserves of $48.0 million).

The Company capitalized $335 thousand of general and administrative costs for the three months ended March 31, 2021 (year ended December 31, 2020 – $80 thousand) and capitalized stock-based compensation expense of $378 thousand for the three months ended March 31, 2021 (year ended December 31, 2020 – $nil).

Q1 2021 Impairment Assessment

At March 31, 2021, there were no indicators of impairment or reversal of impairment identified. As such, an impairment test was not performed.

5. LEASES

Right-of-use assets

The following table reconciles the right-of-use assets by class as at March 31, 2021:

Cost	Office lease $	Surface rentals $	Vehicles $	Total $
Balance at December 31, 2019	170	174	89	433
Additions	289	-	-	289
Dispositions	-	-	(89)	(89)
Balance at December 31, 2020	459	174	-	633
Additions	-	-	-	-
Balance at March 31, 2021	459	174	-	633
Accumulated depreciation				
Balance at December 31, 2019	113	8	23	144
Depreciation expense	86	8	22	116
Dispositions	-	-	(45)	(45)
Balance at December 31, 2020	199	16	-	215
Depreciation expense	33	-	-	33
Balance at March 31, 2021	232	16	-	248
Net book value as at December 31, 2020	260	158	-	418
Net book value as at March 31, 2021	227	158	-	385

Lease liability

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

	March 31, 2021 $	December 31, 2020 $
Lease liability, beginning of period	436	285
Additions	-	288
Dispositions	-	(38)
Interest expense	3	11
Payment of lease liability	(36)	(110)
Lease liability, end of period	403	436

Current portion of lease liability	140	138
Non-current portion of lease liability	263	298
Total lease liability	403	436

During the three months ended March 31, 2021, the weighted average discount rate used was 4.9%.

6. DECOMMISSIONING LIABILITY

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

	March 31, 2021	December 31, 2020
	$	$
Balance, beginning of period	16,718	11,976
Acquired - property acquisition	-	1,709
Additions	3,724	50
Change in estimate (1)	(2,400)	606
Accretion	50	149
Revaluation of liabilities acquired	-	2,228
Balance, end of period	18,092	16,718

(1) Relates to an increase in the risk-free rate partially offset by an increase in the inflation rate. The change in risk-free rate from 1.2% at December 31, 2020 to 2.0% at March 31, 2021 results in a decrease to the decommissioning liability of $3.2 million and the change in inflation rate from 1.5% at December 31, 2020 to 1.7% at March 31, 2021 results in an increase to the decommissioning liability of $0.8 million.

The Company's decommissioning liabilities are based on the Company's net ownership in wells and related infrastructure.

The Company has estimated the net present value of its total decommissioning liabilities to be $18.1 million as at March 31, 2021 (December 31, 2020 - $16.7 million). The total future undiscounted amount of estimated cash flows required to settle these obligations is $30.2 million (December 31, 2020 - $23.6 million). Management estimates the settlement of these obligations will occur over the next 17 to 32 years. At March 31, 2021, a risk-free rate of 2.0% (December 31, 2020 – 1.2%) and an inflation rate of 1.7% (December 31, 2020 – 1.5%) were used to calculate the estimated fair value of the decommissioning liability.

7. WARRANT LIABILITY

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

	March 31, 2021	December 31, 2020
	$	$
Warrant liability, beginning of period	10,305	-
Issued - acquisition	-	6,016
Remeasurement loss on warrant liability	19,195	4,289
Warrant liability, end of period	29,500	10,305

As at March 31, 2021, there were 15 million warrants outstanding which have an exercise price of $2.00 and expire in December 2023. Headwater has the right, after twelve months have elapsed from December 2, 2020 and provided the 20-day volume weighted average share price of the Company's common shares exceeds the exercise price of the warrants, to require the holder to exercise all or a portion of the then-outstanding warrants. The warrants issued were classified as a financial liability as a result of a cashless exercise provision. These warrants are exercisable and have therefore been presented as a current liability in the Statement of Financial Position. In no event will the Company be required to settle the warrants through a cash payment.

The fair value of the warrants on March 31, 2021 and on December 31, 2020 was determined using a Monte Carlo simulation pricing model with the following inputs:

	March 31, 2021	December 31, 2020
Share price	$3.91	$2.39
Risk-free interest rate	0.5%	0.3%
Expected life (years) (1)	0.7	0.9
Expected volatility (2)	57%	56%

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

8. CAPITAL STOCK

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

b) Issued and outstanding

	March 31, 2021		December 31, 2020	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of period	195,106	387,393	88,147	247,332
Recapitalization Transaction:				
Common shares issued for cash proceeds	-	-	54,347	50,000
Allocation to warrants	-	-	-	(7,680)
Common shares issued on acquisition	-	-	50,000	96,500
Share issue costs	-	-	-	(2,036)
Exercise of stock options	51	26	2,550	3,198
Exercise of Warrants	417	531	62	79
Balance, end of period	195,574	387,950	195,106	387,393

Stock Options

During the three months ended March 31, 2021, 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.

Warrants

During the three months ended March 31, 2021, 417 thousand Warrants were exercised for 417 thousand common shares for cash proceeds of $384 thousand. The associated fair value of the Warrants of $147 thousand was transferred to capital stock.

2020 Recapitalization Transaction

On March 4, 2020, the Company completed a recapitalization transaction (the "Recapitalization Transaction"). The Recapitalization Transaction involved the following:

- A non-brokered private placement of 21,739,130 units of the Company at a price of $0.92 per unit for aggregate gross proceeds of $20.0 million. Each unit was comprised of one common share and one common share purchase warrant ("Warrant") of the Company. Each Warrant entitles the holder to purchase one common share at a price of $0.92 per common share for a period of 4 years from the issuance date. Pursuant to the rules of the TSX, the non-brokered private placement was approved by shareholders of the Company at a special meeting held on March 4, 2020. As at March 31, 2021, the Warrants are fully vested and exercisable.

- Concurrently with the closing of the non-brokered private placement, the appointment of a new management team and reconstitution of the Board of Directors was completed.

- A brokered private placement of 32,608,696 subscription receipts ("Subscription Receipts") of the Company, which were issued at a price of $0.92 per Subscription Receipt through a syndicate of dealers for aggregate gross proceeds of $30.0 million, was completed on February 11, 2020. Pursuant to the terms of the Subscription Receipts, upon completion of the non-brokered private placement, reconstitution of the Board of Directors and appointment of the new management team on March 4, 2020, the net proceeds of the brokered private placement were released to the Company and each holder of Subscription Receipts received one common share for each Subscription Receipt held.

- Pursuant to the Recapitalization Transaction, the Company incurred $4,382 thousand of transaction costs and $1,905 thousand of share issue costs.

c) Warrants

	March 31, 2021		December 31, 2020	
	Number of warrants	Amount	Number of warrants	Amount
		$		$
Balance, beginning of period	21,677	7,659	-	-
Issued on Recapitalization Transaction	-	-	21,739	7,680
Exercise of Warrants	(417)	(147)	(62)	(21)
Balance, end of period	21,260	7,512	21,677	7,659

At March 31, 2021, there were 21.3 million Warrants outstanding which have an exercise price of $0.92 and expire in March 2024. The fair value of the Warrants is recorded in shareholders' equity. Subsequently, any consideration paid to the Company on the exercise of Warrants along with the fair value of Warrants will be credited to capital stock.

The Warrants issued in connection with the non-brokered private placement during the year ended December 31, 2020 were allocated a fair value of $7,680 thousand. The fair value was estimated using the Black-Scholes model with the following assumptions: expected life of four years; volatility of 50%; risk-free interest rate of 0.9%; and a dividend yield of 0%. The expected volatility was estimated based on a peer group historical volatility over a four-year period.

d) Per share amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding. The Company uses the treasury stock method to determine the impact of dilutive securities. The reconciling items between basic and diluted average common shares outstanding are stock options and warrants.

	Three months ended March 31, 2021	Three months ended March 31, 2020
Weighted average shares outstanding		
Basic	195,322	105,436
Diluted	195,322	105,436

As the Company incurred a net loss for the three months ended March 31, 2021, in computing the diluted net loss per share, the effect of stock options and warrants were excluded as they were anti-dilutive.

9. STOCK-BASED COMPENSATION

a) Stock options

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

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

	Three months ended March 31, 2021		Year ended December 31, 2020	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	7,978	$ 1.32	3,490	$ 0.79
Granted	2,965	$ 4.17	7,905	$ 1.34
Forfeited, cancelled or expired	-	-	(867)	$ 0.79
Exercised [(1)]	(67)	$ 0.70	(2,550)	$ 0.82
Options outstanding, end of period	10,876	$ 2.10	7,978	$ 1.32
Options exercisable, end of period	1,857	$ 1.04	169	$ 0.70

(1) The Company's weighted average exercise price, at the date of exercise, for stock options exercised during the three months ended March 31, 2021 was $0.70 per common share (three months ended March 31, 2020 - $1.26 per common share).

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

	March 31, 2021	December 31, 2020
Weighted average fair value of options granted	$ 1.52	$ 0.61
Risk-free interest rate	0.4%	0.3%
Expected forfeiture rate	9.6%	9.7%
Expected life (years)	2.5	3.6
Expected volatility [(1)]	60%	60%

(1) During the three months ended March 31, 2021, the expected volatility was estimated based on a peer group historical volatility.

The range of exercise prices of stock options outstanding and exercisable as at March 31, 2021 is as follows:

	Outstanding options			Exercisable options	
Exercise prices	Number of options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$ 0.68 - \$ 1.00	806	2.87	\$ 0.93	102	\$ 0.71
\$ 1.01 - \$ 2.00	5,465	2.99	\$ 1.06	1,755	\$ 1.06
\$ 2.01 - \$ 3.00	2,290	3.73	\$ 2.50	-	-
\$ 3.01 - \$4.66	2,315	3.95	\$ 4.57	-	-
Total	10,876	3.34	\$ 2.10	1,857	\$ 1.04

For the three months ended March 31, 2021, the Company recorded stock-based compensation expense of \$462 thousand and capitalized stock-based compensation expense of \$378 thousand with a corresponding increase to contributed surplus of \$840 thousand with respect to stock options (three months ended March 31, 2020 - \$30 thousand stock-based compensation recovery with a corresponding decrease to contributed surplus).

b) Deferred share units

The Company has a deferred share unit ("DSU") plan for directors. Each vested DSU will automatically be redeemed on the third business day after the date the director ceases to be a director of Headwater. When redeemed, each vested DSU will be paid based on the weighted average trading price of the common shares over the five previous trading days.

The following table summarizes the changes in the outstanding DSUs for the periods:

	March 31, 2021		December 31, 2020	
	Number of DSUs	Amount	Number of DSUs	Amount
		\$		\$
DSUs, beginning of period	38	91	447	322
DSUs redeemed during the period (1)	-	-	(409)	(535)
Fair value adjustment during the period	-	58	-	304
DSUs, end of period	38	149	38	91

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

The DSU liability as at 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).

10. SALES

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

	Three months ended March 31,	
	2021	2020
	\$	\$
Heavy oil	19,155	-
Natural gas	5,718	2,009
Gathering, processing and transportation	588	262
Natural gas liquids	31	37
	25,492	2,308

The Company’s heavy oil, natural gas and NGL revenues for the three months ended March 31, 2021 were primarily derived from variable priced contracts based on index prices.

Included in accounts receivable as at March 31, 2021 is $11.7 million (December 31, 2020 - $4.5 million) of accrued heavy oil, natural gas and NGL sales related to March 2021 production.

11. INTEREST INCOME AND OTHER

Interest income and other consist of the following:

	Three months ended March 31, 2021	2020
	$	$
Interest income	204	358
Foreign exchange gains (losses)	(92)	198
Accretion	(50)	(53)
Interest on lease liability	(3)	(1)
	59	502

12. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended March 31, 2021	2020
	$	$
Change in non-cash operating working capital:		
Accounts receivable	(7,735)	505
Inventories	130	-
Prepaids and deposits	(39)	(145)
Accounts payable and accrued liabilities	5,948	86
	(1,696)	151
Change in non-cash investing working capital:		
Accounts payable and accrued liabilities	27,775	(164)
	27,775	(164)

13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

a) The Company is exposed to the following risks:

i) Commodity price risk

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

The Company has the following outstanding financial derivative commodity contracts as at March 31, 2021:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT (1)	Fixed	Apr 1- Apr 30, 2021	5,000 mmbtu	Cdn$3.88/mmbtu
Natural Gas	AGT Basis (2)	Differential	Dec 1- Mar 31, 2022	2,500 mmbtu	Cdn$4.16/mmbtu
Crude Oil	WCS Basis (3)	Differential	Oct 1- Dec 31, 2021	2,000 bbls	US$13.16/bbl

(1) AGT = Algonquin city-gates
(2) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn$4.16/mmbtu
(3) Headwater pays on WCS (Western Canadian Select) while counterparty pays on WTI (West Texas Intermediate) less US$13.16/bbl

As security for certain financial derivative commodity contracts, the counterparty has the authority to hold Headwater funds in the amount of US$6.5 million. As at March 31, 2021, US$106 thousand 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.

Financial derivatives

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

	Three months ended March 31,	
	2021	2020
	$	$
Gains (losses) on financial derivatives:		
- realized gains (losses)	(551)	3,937
- unrealized losses	(254)	(1,481)
Gains (losses) on financial derivatives	(805)	2,456

The fair value of the financial derivatives liability of $180 thousand as at March 31, 2021 is based on estimated future crude oil and natural gas prices as of that date. The fair values of these financial derivative commodity contracts are sensitive to changes in the crude oil and natural gas reference prices. Holding other assumptions constant, if WCS and AGT prices increased (decreased) by 10%, the fair value of the financial derivatives payable would increase (decrease) by $447 thousand.

ii) Foreign currency risk

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

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

The Company has the following outstanding foreign exchange contract as at March 31, 2021:

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

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

	Three months ended March 31	
(thousands of U.S. dollars)	2021	2020
	$	$
Cash	1,872	33
Accounts receivable	8,890	1,262
Financial instruments in U.S. dollars	10,762	1,295

At March 31, 2021, a 5% decrease in the CAD$/USD$ exchange rate would have resulted in an increase of approximately $677 thousand to the Company's net loss (March 31, 2020 – $92 thousand increase to net loss). Conversely, a 5% increase in the CAD$/USD$ exchange rate would have resulted in a decrease of approximately $677 thousand in the Company's net loss (March 31, 2020 – $92 thousand decrease in net loss).

Fair Value Measurement

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

- Level 1 – Values are used based on unadjusted quoted prices available in active markets for identical assets and liabilities as of the reporting date.
- Level 2 – Values are based on inputs, including forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace. Prices in Level 2 are either directly or indirectly observable as of the reporting date.
- Level 3 – Values are based on prices or valuation techniques that are not based on observable market data.

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

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

iii) Credit risk

As at March 31, 2021, 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 three months ended March 31, 2021, the Company sold its crude oil and natural gas production to various counterparties with one counterparty accounting for 66% of sales. Headwater mitigates the risk of loss by ensuring its major counterparties are investment grade as ranked by reputable credit agencies. Headwater historically has not experienced any collection issues. Payment of revenues from all counterparties occurs on the 25^{th} 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 March 31, 2021, 100% of the Company's accounts receivables were outstanding for less than 30 days. Trade receivables generally have a 30-day term and have all been collected subsequent to March 31, 2021. As at March 31, 2021, the Company's receivables consisted of $12,289 thousand (December 31, 2020 - $4,980 thousand) from crude oil and natural gas marketers, $636 thousand (December 31, 2020 - $237 thousand) from its joint venture partner and $285 thousand (December 31, 2020 - $258 thousand) related to accrued interest.

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company manages liquidity risk through its working capital surplus and an actively managed operating and capital expenditure budgeting process. As at March 31, 2021, the Company was holding cash and cash equivalents of $81.6 million.

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

b) Management of capital

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

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

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

Headwater has a development agreement with Cenovus Energy Inc. ("Cenovus") under which the Company committed to spend $100 million in capital expenditures on certain oil and gas properties by December 31, 2022 unless otherwise extended by Cenovus. The Company expects to fund these expenditures through its working capital surplus and cash flows from operating activities. As at March 31, 2021, the remaining capital commitment is approximately $63 million.

The Company has not paid or declared any dividends.

14. RELATED PARTY TRANSACTION

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 gross overriding royalty ("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.

15. COMMITMENTS

a) Commitments

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) At March 31, 2021, Headwater has the following transportation commitments:
  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) Refer to Note 14. 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. Refer to note 5.

b) Letters of credit

As at March 31, 2021, the Company had two standby letters of credit issued by a Canadian chartered bank in the amounts of $350 thousand and US$85 thousand relating to transportation arrangements. The standby letters of credit are supported by cash which is recorded in restricted cash in the Statement of Financial Position.

16. 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