Management's Report

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

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

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

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

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

(signed) "*Neil Roszell*"

Neil Roszell
Chief Executive Officer and Chairman

(signed) "*Ali Horvath*"

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

March 10, 2022

KPMG LLP
205 5th Avenue SW
Suite 3100
Calgary AB T2P 4B9
Tel (403) 691-8000
Fax (403) 691-8008
www.kpmg.ca

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Headwater Exploration Inc.

Opinion

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

- the statements of financial position as at December 31, 2021 and 2020
- the statements of income and comprehensive income for the years then ended
- the statements of changes in shareholders' equity for the years then ended
- the statements of cash flows for the years then ended
- and notes to the financial statements, including a summary of significant accounting policies

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

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2021 and 2020, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Basis for Opinion

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

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

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

KPMG LLP, an Ontario limited liability partnership and member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. KPMG Canada provides services to KPMG LLP.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements for the year ended December 31, 2021. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

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

Assessment of the impact of estimated proved and probable oil and gas reserves on depletion expense for the Alberta cash-generating unit ("CGU")

Description of the matter

We draw attention to note 2, note 3, and note 7 to the financial statements. Depletion of oil and gas properties is calculated using the unit-of-production basis over the estimated proved and probable oil and gas reserves before royalties. Depletion is calculated at the cash-generating unit ("CGU") level and takes into account expenditures incurred to date together with forecasted future development costs to develop the proved plus probable oil and gas reserves. The Company recorded depletion expense related to its oil and gas properties of $44.0 million for the year ended December 31, 2021, of which a portion relates to the Alberta CGU. The estimate of proved and probable oil and gas reserves for the Alberta CGU includes significant assumptions related to:

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

The Company engages an independent third party reserve evaluator to estimate the proved and probable oil and gas reserves for the Alberta CGU.

Why the matter is a key audit matter

We identified the assessment of the impact of estimated proved and probable oil and gas reserves on depletion expense for the Alberta CGU as a key audit matter. Significant auditor judgement was required to evaluate the results of our audit procedures regarding the estimate of proved and probable oil and gas reserves for the Alberta CGU.

How the matter was addressed in the audit

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

We assessed the depletion expense calculation for compliance with IFRS as issued by the IASB.

With respect to the estimate of proved and probable oil and gas reserves for the Alberta CGU:

- We evaluated the competence, capabilities and objectivity of the independent third party reserve evaluator engaged by the Company
- We compared the forecasted oil and gas commodity prices to those published by other independent third party reserve evaluators
- We compared the 2021 actual production, operating costs, royalty costs and development costs of the Company to those estimates used in the prior year's estimate of proved oil and gas reserves to assess the Company's ability to accurately forecast
- We evaluated the appropriateness of forecasted production and forecasted operating costs, royalty costs and future development cost assumptions by comparing to 2021 actual results. We took into account changes in conditions and events affecting the Company to assess the adjustments or lack of adjustments made by the Company in arriving at the assumptions.

Other Information

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

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

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

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

We have nothing to report in this regard.

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

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

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

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

Auditors' Responsibilities for the Audit of the Financial Statements

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

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

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

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

We also:

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

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

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

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.
- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.
- Determine, from the matters communicated with those charged with governance, those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditors' report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our auditors' report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

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

KPMG LLP

Chartered Professional Accountants

Calgary, Canada
March 10, 2022

HEADWATER EXPLORATION INC.
Statements of Financial Position

(thousands)	December 31, 2021 $	December 31, 2020 $
ASSETS		
Current assets		
Cash and cash equivalents	114,703	76,772
Restricted cash (notes 18 & 20)	350	1,827
Accounts receivable (note 18)	30,601	5,475
Financial derivative receivable (note 18)	770	74
Inventories	807	571
Prepaids and deposits	489	448
Total current assets	147,720	85,167
Exploration and evaluation assets (note 6)	28,993	27,101
Property, plant and equipment (note 7)	310,290	187,664
Right-of-use assets (note 8)	1,469	418
Other assets	335	335
Total assets	488,807	300,685
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 18)	52,970	4,105
Deferred share units liability (note 12)	196	91
Financial derivative liability (note 18)	3,924	-
Current portion of lease liability (note 8)	855	138
Warrant liability (note 10)	-	10,305
Total current liabilities	57,945	14,639
Lease liability (note 8)	695	298
Decommissioning liability (note 9)	27,600	16,718
Deferred income tax liability (note 13)	4,776	-
Total liabilities	91,016	31,655
Shareholders' Equity		
Capital stock (note 11)	469,521	387,393
Warrants (note 11)	5,437	7,659
Contributed surplus	14,686	11,659
Deficit	(91,853)	(137,681)
Total shareholders' equity	397,791	269,030
Total liabilities and shareholders' equity	488,807	300,685

Commitments (note 20)
Subsequent events (note 21)

See accompanying notes to the financial statements

Approved on behalf of the Board of Directors:

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

(signed) "Neil Roszell"
Neil Roszell, Director

HEADWATER EXPLORATION INC.
Statements of Income and Comprehensive Income

	Year ended December 31,	
	2021	2020
(thousands, except per share data)	$	$
REVENUE		
Sales (note 14)	190,940	9,499
Royalties	(25,938)	(656)
	165,002	8,843
Gains (losses) on financial derivatives (note 18)	(2,273)	4,108
	162,729	12,951
EXPENSES		
Blending and transportation	31,778	1,115
Production	12,513	2,899
General and administrative	3,981	2,835
Transaction costs	-	7,330
Remeasurement loss on warrant liability (note 10)	32,599	4,289
Stock-based compensation (note 12)	2,726	1,477
Depletion and depreciation (note 7)	44,388	5,895
Exploration and evaluation expense	-	3,821
Impairment reversal (note 7)	(16,293)	(15,054)
Other write-downs and losses	-	27
	111,692	14,634
Interest income and other expense (note 15)	(145)	1,113
Income (loss) before income taxes	50,892	(570)
Deferred income tax expense (recovery) (note 13)	5,064	(7,277)
Net income and comprehensive income	**45,828**	**6,707**
Net income per share (note 11)		
Basic	0.23	0.05
Diluted	0.21	0.05

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Statements of Cash Flows

	Year ended December 31, 2021	2020
(thousands)	$	$
OPERATING		
Net income	45,828	6,707
Items not involving cash:		
Unrealized losses on financial derivatives (note 18)	3,228	1,407
Remeasurement loss on warrant liability	32,599	4,289
Stock-based compensation	2,726	1,477
Depletion and depreciation	44,388	5,895
Exploration and evaluation expense	-	3,821
Impairment reversal	(16,293)	(15,054)
Other write-downs and losses	-	27
Accretion and finance charges (notes 8 & 9)	376	160
Deferred income tax expense (recovery)	5,064	(7,277)
Change in non-cash operating working capital (note 17)	(6,260)	(1,222)
Cash flows provided by operating activities	111,656	230
FINANCING		
Issue of common shares, net of costs (note 11)	-	47,964
Payment of lease liability (note 8)	(340)	(110)
Proceeds from exercise of stock options (note 11)	18	2,077
Proceeds from exercise of warrants (note 11)	35,724	58
Cash flows provided by financing activities	35,402	49,989
INVESTING		
Capital expenditures – exploration and evaluation (note 6)	(14,409)	(469)
Capital expenditures – property, plant and equipment (note 7)	(125,980)	(1,808)
Property acquisition (note 5)	-	(32,781)
Restricted cash	1,477	(797)
Change in non-cash investing working capital (note 17)	29,785	1,451
Cash flows used in investing activities	(109,127)	(34,404)
Change in cash and cash equivalents	37,931	15,815
Cash and cash equivalents, beginning of year	76,772	60,957
Cash and cash equivalents, end of year	114,703	76,772

	2021	2020
Cash and cash equivalents consist of:		
Cash	114,703	61,772
Short-term investments	-	15,000
Cash and cash equivalents, end of year	114,703	76,772

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Statements of Changes in Shareholders' Equity

(thousands)	Note	Capital stock $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' equity $
Balance at January 1, 2020		**247,332**	**-**	**11,366**	**(144,388)**	**114,310**
Issued on Recapitalization Transaction	11	50,000	-	-	-	50,000
Allocation to Warrants	11	(7,680)	7,680	-	-	-
Issued on acquisition	11	96,500	-	-	-	96,500
Share issue costs	11	(2,036)	-	-	-	(2,036)
Exercise of stock options	11	3,198	-	(1,121)	-	2,077
Exercise of Warrants	11	79	(21)	-	-	58
Stock-based compensation		-	-	1,414	-	1,414
Net income		-	-	-	6,707	6,707
Balance at December 31, 2020		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**
Balance at January 1, 2021		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**
Deferred income taxes on share issue costs	11	288	-	-	-	288
Exercise of warrants by Cenovus	11	72,904	-	-	-	72,904
Exercise of stock options	11	990	-	(972)	-	18
Exercise of Warrants	11	7,946	(2,222)	-	-	5,724
Stock-based compensation		-	-	3,999	-	3,999
Net income		-	-	-	45,828	45,828
Balance at December 31, 2021		**469,521**	**5,437**	**14,686**	**(91,853)**	**397,791**

See accompanying notes to the financial statements

HEADWATER EXPLORATION INC.
Notes to the Financial Statements

As at and for the years ended December 31, 2021 and 2020

(All tabular amounts in thousands, unless otherwise stated)

1. NATURE OF OPERATIONS AND GENERAL INFORMATION

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

On March 4, 2020, Headwater announced the completion of the Recapitalization Transaction (defined herein), whereby the Company raised aggregate gross proceeds of $50 million pursuant to two equity private placements, a new management team was appointed and the Board of Directors of the Company was reconstituted. Details of the Recapitalization Transaction are provided in note 11 of these audited annual financial statements.

On December 2, 2020, Headwater acquired the entirety of Cenovus' position in the Marten Hills area of Alberta for total consideration of $135.3 million, comprised of $32.8 million of cash, $96.5 million of common shares and $6.0 million of warrants. More details are provided in note 5 of these audited annual financial statements.

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

2. BASIS OF PREPARATION

Statement of compliance

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

These audited annual financial statements were approved and authorized for issue by the Company’s Board of Directors on March 10, 2022.

Basis of measurement, functional and presentation currency

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

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

Use of estimates and judgments

The preparation of the Company’s financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of

contingent liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions are evaluated at each reporting date and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. 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 outbreak and current market conditions have increased the complexity of estimates and assumptions used to prepare the audited annual financial statements, particularly related to recoverable amounts. The Company will continue to update its significant judgments, estimates and assumptions for COVID-19 and the emergence of new COVID-19 variants as the impacts, if any, on commodity prices and equity markets unfold.

Climate change

The following provides certain disclosures as to the impact of climate change on the amounts recorded in the financial statements as at and for the year ended December 31, 2021. The below is not a comprehensive list or analysis of all climate change impacts and risks.

Emissions, carbon and other regulations impacting climate and climate related matters are constantly evolving. With respect to climate reporting, the International Sustainability Standards Board has issued an IFRS Sustainability Disclosure Standard with the aim to develop sustainability disclosure standards that are globally consistent, comparable and reliable. In addition, the Canadian Securities Administrators have issued a proposed national instrument 51-107 Disclosure of Climate-Related Matters. The cost to comply with these standards, and others that may be developed or evolve over time, has not yet been quantified.

The Company has considered the impact of the evolving worldwide demand for energy and global advancement of alternative sources of energy that are not sourced from fossil fuels in its assessment as a possible indication of impairment of its oil and gas properties. The Company completed the analysis of triggers for impairment as at December 31, 2021 and climate risk/climate change, in of itself, did not result in the Company completing an impairment test. The Company has considered the impact of the evolving worldwide demand for energy and global advancement of alternative sources of energy that are not sourced from fossil fuels in its assessment of depletion on its oil and gas properties. Depletion of the Company's oil and gas properties was based on proved and probable reserves, the life of which is generally less than 20 years. The ultimate period in which global energy markets can transition from carbon-based sources to alternative energy is highly uncertain, however, the majority of the Company's proved and probable reserves per the 2021 reserve report should be realized prior to the elimination of carbon-based energy. At this time, the Company has not capped its reserve life for purposes of calculating depletion expense, however, this estimate will be monitored as the energy evolution continues.

The Company engages a third-party external reserve engineer to prepare the reserve report. The reserve report includes anticipated impacts from emissions related taxes, most notably the reserve report includes estimated carbon tax related to the Company's operations based on the current rate of $50 per tonne.

The evolving energy transition and general sentiment to the oil and gas industry may result in reduced access to capital markets. Management will continue to adjust the capital structure to the dynamic environment.

The Company's financial results for 2021 were not directly impacted from a climate event. In 2021, the Company did not incur material weather related damages to its property, plant and equipment. During 2021, management is not aware of a material disruption in its supply chain or the marketers of the Company's product related to climate events.

The Company maintains insurance coverage that provides a level of insurance for certain events that may arise due to climate change factors; however, the Company's insurance program is subject to limits and various restrictions. No claims were made under the Company's insurance policies in 2021 with respect to climate related matters.

a) Critical Judgments in Applying Accounting Policies

Business Combinations

Business combinations are accounted for using the acquisition method of accounting. The determination of fair value is estimated based on information available at the date of acquisition and requires management to make assumptions and estimates about future events. The assumptions and estimates with respect to determining the fair value of exploration and evaluation assets and property, plant and equipment acquired generally require the most judgment and include estimates of the cash flows associated with proved and probable reserves acquired which is impacted by assumptions related to forecasted production, forecasted operating and royalty costs, future development costs, future crude oil and natural gas commodity prices, foreign exchange rates, and discount rates. Assumptions are also required to determine the fair value of decommissioning liabilities associated with the properties. Changes in any of these assumptions or estimates used in determining the fair value of acquired assets and liabilities could impact the amounts assigned to assets, liabilities (including deferred income tax liabilities) in the acquisition equation. Future net income (loss) will be affected as the fair value on initial recognition impacts future depletion expense, as well as the risk of potential impairment in future periods.

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

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

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

The Company's CGUs as at December 31, 2021 include its Alberta CGU comprised of its Marten Hills assets and its New Brunswick CGU consisting of its McCully 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.

b) Key Sources of Estimation Uncertainty

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

At each reporting date, the Company assesses its 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 and the volume of proved and probable 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 reserve revisions.

ii) Forecasted crude oil and natural gas prices – commodity prices can fluctuate for a variety of reasons including supply and demand fundamentals, inventory levels, exchange rates, weather, and economic and geopolitical factors.

iii) Discount rate – the discount rate used to calculate the net present value of cash flows is based on estimates of an approximate industry peer group weighted average cost of capital. Changes in the general economic environment could result in significant changes to this estimate.

iv) Forecasted operating and royalty costs and future development costs – estimates concerning future drilling and infrastructure costs and production costs required to operate the assets are used in the cash flow model.

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

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

Decommissioning liabilities

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

Valuation of financial instruments

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

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

Valuation of Warrants and stock options

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

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

a) Joint interest

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

b) Foreign currency translation

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

c) Business Combinations

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

Transaction costs associated with the acquisition are expensed when incurred.

d) Cash and cash equivalents and restricted cash

Cash and cash equivalents include cash held with Canadian chartered banks on deposit and/or in highly liquid investments.

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

e) Financial instruments

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

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

i) Financial assets at amortized cost

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

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

ii) Financial liabilities at amortized cost

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

iii) Fair value through profit or loss

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

f) Inventories

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

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

Once the legal right to explore has been acquired, costs directly associated with an exploration activity are capitalized as E&E assets and grouped by licensed exploration area. Costs are capitalized until the technical feasibility and commercial viability of extracting a mineral resource are demonstrable and the presence of reserves has been established, after which capitalized costs are transferred to property, plant and equipment following an assessment for impairment.

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

Exploration and evaluation assets are not depleted.

h) Property, plant and equipment

Oil and gas properties

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

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

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

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

Depletion and depreciation

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

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

The estimated useful lives for depreciable assets are as follows:

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

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

i) Deferred taxes

Deferred income tax is recognized for the temporary differences between the tax basis and carrying value of assets and liabilities. Deferred income tax is measured using the enacted or substantively enacted tax rates expected to be in effect when the deferred income tax assets are estimated to be realized or the deferred income tax liabilities are estimated to be settled.

Deferred tax assets are recognised for unused tax losses, unused tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be used. Future taxable profits are determined based on the reversal of relevant taxable temporary differences. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised; such reductions are reversed when the probability of future taxable profits improves.

j) Leases

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

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

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

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

k) Provisions

Decommissioning liabilities

A decommissioning liability is recognized for the present value of the future cost of abandoning oil and gas wells or facilities and is calculated based on management's best estimate of the expenditure using a combination of publicly available industry benchmarks and internal site-specific information. A decommissioning liability is recognized only when a legal or constructive obligation exists. The liability is measured at each reporting date at the fair value of the estimated expenditures expected to settle the obligation using a risk-free interest rate. An equivalent amount is capitalized as part of exploration and evaluation assets or property, plant and equipment and depleted along with the related asset.

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

General

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

l) Capital stock

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

m) Revenue recognition

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

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

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

Gathering, processing and transportation

In New Brunswick, the Company has collaborative arrangements with its joint venture partner to gather, process and transport natural gas production from the McCully field through Headwater's production facilities.

The gathering, processing and transportation fees are calculated based on the use of these facilities and include a recovery of capital and a recovery of operating expenses.

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

n) Transportation and blending

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

Headwater is required to purchase commodity products from third parties to utilize in blending activities. Headwater subsequently sells the blended products to its customers. These transactions are presented in revenue with the related expense included in blending and transportation expense recognized in the Statement of Income and Comprehensive Income.

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

o) Impairment of non-financial assets

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

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

p) Stock-based compensation

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

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

q) Government grants

Government grants are recognized when there is reasonable assurance that the grant will be received, and all conditions associated with the grant are met. Claims under government grant programs related to income are deducted in reporting the related expense and are recorded in the period in which the eligible expenses were incurred.

r) Net income per share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the year. For the diluted net income per share calculation, the weighted average number of common shares outstanding is adjusted for the potential number of common shares which may have a dilutive effect on net income per share. The weighted average number of diluted shares is calculated in accordance with the treasury stock method. The treasury stock method assumes that the proceeds received from the exercise of all potentially dilutive instruments are used to repurchase common shares at the average market price.

4. SUMMARY OF NEW ACCOUNTING POLICIES AND DISCLOSURES

Future accounting pronouncements

On January 23, 2020, the IASB announced an amendment to IAS 1 "Presentation of financial statements" re: *classification of liabilities as current or non-current* which is effective for annual periods beginning on or after January 1, 2023. The amendment clarifies that the classification of liabilities as current or non-current should be based on rights that are in existence at the end of the reporting period.

On May 7, 2021, the IASB announced an amendment to IAS 12 "Income Taxes" re: *deferred tax assets and liabilities arising from a single transaction* which is effective for annual periods beginning on or after January 1, 2023. The amendment narrows the scope of the initial recognition exemption so that is does not apply to transactions that give rise to equal and offsetting temporary differences. As a result, companies will need to recognize a deferred tax asset and a deferred tax liability for temporary differences arising on initial recognition of a lease and of a decommissioning provision.

The Company does not plan to early adopt any amendments issued but not yet effective and has not yet assessed their impact.

5. PROPERTY ACQUISITION

Marten Hills Property Acquisition

On November 8, 2020, the Company entered into a purchase and sale agreement with Cenovus Energy Inc. ("Cenovus") to acquire the entirety of Cenovus' position in the Marten Hills area of Alberta. The acquisition was completed on December 2, 2020, for 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 of warrants. The effective date of the acquisition was October 1, 2020.

The acquired assets include 100% working interest in Marten Hills heavy oil properties and undeveloped land. The Company assumed certain transportation commitments from Cenovus and was required to spend $100 million in capital expenditures on the acquired assets by December 31, 2022. As at December 31, 2021, Headwater had satisfied this capital commitment.

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

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

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

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

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

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

The fair value of the warrants issued was estimated using a Monte Carlo simulation pricing model. The warrants issued were considered a financial derivative carried at fair value through profit or loss. Cenovus exercised all of its outstanding warrants on December 23, 2021, following a call notice issued by Headwater. Refer to note 10 for more details.

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

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

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

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

Exploration and evaluation assets consist of the Company's undeveloped land and seismic for projects in which the technical feasibility or commercial viability has yet to be determined.

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

	December 31, 2021	December 31, 2020
	$	$
Balance, beginning of year	27,101	3,816
Acquired - property acquisition (note 5)	-	26,637
Additions	14,409	469
Transfers to PP&E	(12,517)	-
Expensed	-	(3,821)
Balance, end of year	28,993	27,101

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

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

The Company's property, plant and equipment includes oil and gas properties and corporate assets. Oil and gas properties include the Company's interest in developed petroleum and natural gas properties, as well as interests in facilities and pipelines.

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

	Oil and gas properties	Corporate	Total
Cost	$	$	$
Balance at December 31, 2019	324,448	2,684	327,132
Acquired – property acquisition (note 5)	119,636	-	119,636
Additions	1,753	55	1,808
Changes in decommissioning liabilities	2,884	-	2,884
Balance at December 31, 2020	448,721	2,739	451,460
Additions	127,345	13	127,358
Transfers from E&E	12,517	-	12,517
Changes in decommissioning liabilities	10,541	-	10,541
Balance at December 31, 2021	599,124	2,752	601,876
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	44,007	76	44,083
Impairment reversal	(16,293)	-	(16,293)
Balance at December 31, 2021	289,359	2,227	291,586
Net book value at December 31, 2020	187,076	588	187,664
Net book value at December 31, 2021	309,765	525	310,290

Future development costs required to develop proved plus probable reserves in the amount of $94.3 million were included in the depletion calculation for the Company's oil and gas properties for the year ended December 31, 2021 (December 31, 2020 – $48.0 million).

The Company capitalized $0.9 million of general and administrative costs for the year ended December 31, 2021 (December 31, 2020 – $0.1 million) and capitalized stock-based compensation expense of $1.4 million for the year ended December 31, 2021 (December 31, 2020 – $nil).

Indicators of Impairment

The Company concluded there are no indicators of impairment for its Alberta or New Brunswick CGUs as at December 31, 2021.

Impairment Reversal – New Brunswick CGU – Q3 2021

In the third quarter of 2021, due to a significant increase in forecast natural gas pricing, the Company determined an indicator of impairment reversal was present for its New Brunswick CGU. As a result, the Company completed an impairment reversal test and recognized a reversal of previous impairment losses of $16.3 million; this amount represents the full amount available to be reversed.

The recoverable amount was estimated based on the fair value less costs of disposal ("FVLCD") methodology which is calculated using the present value of the CGU's estimated cash flows associated with proved and probable natural gas reserves. The cash flow information was derived from an internal reserve report on the Company's McCully assets which was prepared by management as of September 30, 2021. The projected cash flows used in the FVLCD calculation reflect market assessments of key assumptions as at September 30, 2021, including long-term forecasts for natural gas commodity prices, inflation rates and foreign exchange rates (Level 3 fair value inputs). Cash flow forecasts are also based on the Company's reserves and individual well production profiles, operating and royalty costs and future development costs. Royalty rates used in the FVLCD calculation are consistent with the New Brunswick government's royalty regime in effect as of September 30, 2021.

The discount rate used in the impairment reversal calculation was 12% and was determined based on a peer group weighed average cost of capital factoring in risks specific to the types of reserves. The carrying value of the New Brunswick CGU at September 30, 2021 was $48.9 million prior to any impairment reversal.

Forecast natural gas commodity pricing used in the FVLCD calculation as at September 30, 2021 reflects the benchmark prices set forth in the table below. McCully natural gas prices were calculated by adjusting the Algonquin city-gates natural gas prices to reflect the expected premiums received at Headwater's delivery point, net of transportation costs, if applicable, and heat content.

	2021	2022	2023	2024	2025	2026 – 2030	Thereafter
Algonquin city-gates ($US/mmbtu)	10.50	7.25	5.44	4.37	4.46	4.55 – 4.92	+2%/year
McCully ($CDN/mcf) (1)	17.56	12.43	8.93	6.25	6.86	7.00 – 7.57	+2%/year
Exchange rate ($US/$CDN)	0.80	0.80	0.80	0.80	0.80	0.80	0.80

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

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

As at September 30, 2021, a 1% increase in the discount rate and/or a 5% decrease in forecast operating cash flows would result in the following reduction to the Company's impairment reversal for the period:

	Decrease to impairment reversal
	$
1% increase in discount rate	-
5% decrease in cash flows	(268)
1% increase in discount rate and 5% decrease in cash flows	(2,210)

Impairment Reversal – New Brunswick CGU – Q4 2020

In the fourth quarter of 2020, due to an increase in proved plus probable natural gas reserves as a result of improved recovery and technical revisions, the Company determined an indicator of impairment reversal was present for its New Brunswick CGU. As a result, the Company completed an impairment reversal test and recognized a reversal of previous impairment losses of $15.1 million.

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

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

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

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

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

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

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

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

8. LEASES

Right-of-use ("ROU") asset

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

Cost	Office and equipment leases	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	1,419	-	-	1,419
Dispositions	(93)	-	-	(93)
Balance at December 31, 2021	1,785	174	-	1,959
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	313	8	-	321
Dispositions	(46)	-	-	(46)
Balance at December 31, 2021	466	24	-	490
Net book value at December 31, 2020	260	158	-	418
Net book value at December 31, 2021	1,319	150	-	1,469

Lease liability

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

	December 31, 2021	December 31, 2020
	$	$
Lease liability, beginning of year	436	285
Additions	1,419	288
Dispositions	-	(38)
Interest expense	35	11
Payment of lease liability	(340)	(110)
Lease liability, end of year	1,550	436
Current portion of lease liability	855	138
Non-current portion of lease liability	695	298
Total lease liability	1,550	436

The weighted average discount rate as at December 31, 2021 is 5.4%. The Company did not enter into any short-term leases during the year ended December 31, 2021.

9. DECOMMISSIONING LIABILITY

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

	December 31, 2021	December 31, 2020
	$	$
Balance, beginning of year	16,718	11,976
Acquired - property acquisition (note 5)	-	1,709
Additions	10,772	50
Change in estimate [(1)]	(231)	606
Liabilities settled	-	-
Accretion	341	149
Revaluation of liabilities acquired	-	2,228
Balance, end of year	27,600	16,718

(1) Relates to changes in the risk-free rate and inflation rate. Of this amount, a $2.0 million downward revision is a result of the increase in risk-free rate over the period from 1.2% at December 31, 2020 to 1.7% at December 31, 2021 and a $1.8 million upward revision is a result of the increase in inflation rate over the period from 1.5% at December 31, 2020 to 1.8% at December 31, 2021.

The underlying cost estimates are derived from a combination of published industry benchmarks as well as site specific information. The Company has estimated the net present value of its total asset retirement obligations to be $27.6 million as at December 31, 2021 (December 31, 2020 - $16.7 million). The total future inflated and undiscounted amount of estimated cash flows required to settle these obligations is $40.7 million (December 31, 2020 - $23.6 million). Management estimates the settlement of these obligations will occur over the next 16 to 32 years. At December 31, 2021, a risk-free rate of 1.7% (December 31, 2020 – 1.2%) and an inflation rate of 1.8% (December 31, 2020 – 1.5%) were used to calculate the estimated fair value of the decommissioning liability.

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

10. WARRANT LIABILITY

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

	December 31, 2021	December 31, 2020
	$	$
Warrant liability, beginning of year	10,305	-
Issued - property acquisition (note 5)	-	6,016
Remeasurement loss on warrant liability	32,599	4,289
Exercise of warrants	(42,904)	-
Warrant liability, end of year	-	10,305

The Company's warrant liability is associated with the 15 million warrants issued to Cenovus as partial consideration for the Marten Hills assets acquired in December 2020 (see note 5). The warrants issued were classified as a financial liability as a result of a cashless exercise provision.

Cenovus exercised all of its outstanding warrants on December 23, 2021, following a call notice issued by Headwater. The warrants were fair valued on the exercise date. The total fair value, along with the proceeds received, were credited to capital stock. Total proceeds paid to the Company on exercise were $30 million.

The fair value of the warrants on December 23, 2021 and on December 31, 2020 was determined using a Monte Carlo simulation pricing model with the following inputs:

	December 23, 2021	December 31, 2020
Share price	$4.86	$2.39
Risk-free interest rate	1.3%	0.3%
Expected life (years) [(1)]	-	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.

11. CAPITAL STOCK

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

b) Issued and outstanding

	December 31, 2021		December 31, 2020	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of year	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 property acquisition	-	-	50,000	96,500
Share issue costs	-	-	-	(2,036)
Deferred income taxes on share issue costs	-	288	-	-
Exercise of warrants by Cenovus (note 10)	15,000	72,904	-	-
Exercise of stock options	1,299	990	2,550	3,198
Exercise of Warrants	6,276	7,946	62	79
Balance, end of year	217,681	469,521	195,106	387,393

Cenovus Warrants

On December 23, 2021, Cenovus exercised 15 million warrants for 15 million common shares for total proceeds of $30 million. The total fair value of $42.9 million, along with the proceeds received, were credited to capital stock.

Stock Options

During the year ended December 31, 2021, 1,726 thousand stock options were exercised for 1,282 thousand common shares on a cashless basis. 17,000 stock options were exercised for 17,000 common shares for total proceeds of $18 thousand. Contributed surplus related to the options exercised of $972 thousand was transferred to capital stock.

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

Warrants

During the year ended December 31, 2021, 6,290 thousand Warrants were exercised for 6,276 thousand common shares for total proceeds of $5.7 million. The associated fair value of the Warrants of $2,222 thousand, along with the proceeds received, were transferred to capital stock.

Marten Hills Property Acquisition

In December 2020, Headwater issued 50 million common shares to Cenovus as part of the consideration for the acquired assets valued at a closing price of $1.93 per common share.

Recapitalization Transaction

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

- A non-brokered private placement of 21,739,130 units of the Company at a price of $0.92 per unit for aggregate gross proceeds of $20.0 million. Each unit was comprised of one common share and one common share purchase warrant ("Warrant") of the Company. Each Warrant entitles the holder to purchase one common share at a price of $0.92 per common share for a period of 4 years from the issuance date. The Warrants vest and become exercisable as to one-third upon the 20-day volume weighted average price of the common shares equaling or exceeding $1.30, $1.60 and $1.90, respectively. Pursuant to the rules of the TSX, the non-brokered private placement was approved by shareholders of the Company at a special meeting held on March 4, 2020.

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

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

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

c) Warrants

	December 31, 2021		December 31, 2020	
	Number of Warrants	Amount	Number of Warrants	Amount
		$		$
Balance, beginning of year	21,677	7,659	-	-
Recapitalization Transaction:				
Warrants issued	-	-	21,739	7,680
Warrants exercised	(6,290)	(2,222)	(62)	(21)
Balance, end of year	15,387	5,437	21,677	7,659

As at December 31, 2021, there were 15.4 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 as part of the Recapitalization Transaction were allocated a fair value of $7,680 thousand. The fair value was estimated using the Black-Scholes pricing model with the following assumptions: expected life of four years; volatility of 50%; risk-free interest rate of 0.9%; and a dividend yield of 0%. The expected volatility was estimated based on a peer group historical volatility over a four-year period.

As at December 31, 2021, the Warrants are fully vested. The remaining Warrants will provide aggregate cash proceeds of approximately $14 million to the Company, if exercised by the holders.

d) Per share amounts

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

	December 31, 2021	December 31, 2020
Weighted average shares outstanding		
Basic	199,802	139,379
Effect of stock options	4,077	262
Effect of Warrants	11,982	5,736
Diluted	215,861	145,377

12. STOCK-BASED COMPENSATION

a) Stock options

The Company has a stock option plan ("Old Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. The exercise price of each option granted under the Old Option Plan is based on the closing price of the common shares on the TSX on the trading day prior to the date the option was granted. Options granted under the Old Option Plan generally vest equally 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 equally over a three-year period and expire four years from the date of grant.

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

	December 31, 2021		December 31, 2020	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of year	7,978	$ 1.32	3,490	$ 0.79
Granted	3,430	$ 4.22	7,905	$ 1.34
Forfeited or expired	(160)	$ 2.87	(867)	$ 0.79
Exercised [(1)]	(1,743)	$ 1.18	(2,550)	$ 0.82
Options outstanding, end of year	9,505	$ 2.36	7,978	$ 1.32
Options exercisable, end of year	1,083	$ 1.45	169	$ 0.70

(1) The Company's weighted average share price, at the date of exercise, for stock options exercised during the year ended December 31, 2021, was $4.56 per common share (year ended December 31, 2020 - $1.25 per common share).

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

	December 31, 2021	December 31, 2020
Weighted average fair value of options granted	$ 1.54	$ 0.61
Risk-free interest rate	0.4%	0.3%
Expected forfeiture rate	9.5%	9.7%
Expected life (years)	2.5	3.6
Expected volatility (1)	60%	60%

(1) During the years ended December 31, 2021 and December 31, 2020, the expected volatility was estimated based on a peer group historical volatility.

The following table summarizes information regarding stock options outstanding as at December 31, 2021:

	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	513	2.2	$ 0.94	113	$ 0.72
$ 1.01 - $ 2.00	4,263	2.2	$ 1.06	630	$ 1.07
$ 2.01 - $ 3.00	2,003	3.0	$ 2.51	340	$ 2.39
$ 3.01 - $ 5.23	2,726	3.3	$ 4.57	-	-
Total	9,505	2.7	$ 2.36	1,083	$ 1.45

For the year ended December 31, 2021, the Company recorded net stock-based compensation expense of $2.6 million and capitalized stock-based compensation expense of $1.4 million with corresponding increase to contributed surplus of $4.0 million (December 31, 2020 – $1.4 million of stock-based compensation expense with a corresponding increase to contributed surplus).

b) Deferred share units

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

The following table summarizes the changes in the Company's outstanding DSUs during the year:

	December 31, 2021		December 31, 2020	
	Number of DSUs	Amount	Number of DSUs	Amount
		$		$
DSUs, beginning of year	38	91	447	322
DSUs redeemed during the year (1)	-	-	(409)	(535)
Fair value adjustment during the year	-	105	-	304
DSUs, end of year	38	196	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 December 31, 2021, of $196 thousand is based on a fair value of $5.15 per DSU, the Company's closing share price at December 31, 2021 (December 31, 2020 - $2.39 per DSU).

13. INCOME TAXES

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

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

	December 31, 2021	December 31, 2020
	$	$
Net income (loss) before income taxes	50,892	(570)
Blended Canadian statutory tax rate	23.6%	26.3%
Expected income tax expense (recovery)	12,011	(150)
Increase (decrease) resulting from:		
Non-deductible expenses (1)	8,332	-
Change in unrecognized benefit	(15,353)	(13,783)
Change in tax rates	74	6,515
Other	-	141
Deferred income tax expense (recovery)	5,064	(7,277)

(1) Non-deductible expenses primarily relates to stock-based compensation and the remeasurement loss on the warrant liability.

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

The deferred income tax liability is comprised of the following as at December 31, 2021:

Deferred income tax asset (liability)	December 31, 2020	Movement through Statement of Financial Position	Movement through Statement of Income and Comprehensive Income	December 31, 2021
	$	$	$	$
Inventories	-	-	15	(15)
ROU asset/lease liability			(20)	20
E&E/PP&E/decommissioning liability	-	-	13,560	(13,560)
Net financial derivative liability	-	-	(744)	744
Non-capital losses/ITC	-	-	(7,275)	7,275
Share issue costs/transaction costs	-	(288)	(472)	760
	-	(288)	5,064	(4,776)

At December 31, 2020, the Company recognized a deferred tax asset of $nil and had $62.2 million of deductible temporary differences for which no deferred tax asset was recognized.

The Company's non-capital losses expire in years 2039 to 2040.

The amount and timing of reversals of temporary differences will be dependent on a number of factors, including the nature and timing of future capital expenditures and the Company's future operating results.

14. SALES

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

	December 31, 2021	December 31, 2020
	$	$
Heavy oil	178,434	4,400
Natural gas	11,416	4,466
Gathering, processing and transportation	1,028	579
Natural gas liquids ("NGLs")	62	54
	190,940	9,499

Substantially all of the Company's heavy oil, natural gas and NGL revenues for the year ended December 31, 2021 are derived from variable priced contracts based on index prices.

Included in accounts receivable as at December 31, 2021 is $28.2 million (December 31, 2020 - $4.5 million) of accrued heavy oil, natural gas and NGLs sales related to December 2021 production.

15. INTEREST INCOME AND OTHER EXPENSE

Interest income and other expense consists of the following:

	December 31, 2021	December 31, 2020
	$	$
Interest income	663	1,144
Foreign exchange gains (losses)	(432)	129
Accretion on decommissioning liability (note 9)	(341)	(149)
Interest on lease liability (note 8)	(35)	(11)
	(145)	1,113

16. EXPENSES BY NATURE

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

	December 31, 2021	December 31, 2020
	$	$
Production	482	597
General and administrative	3,007	1,320
Stock-based compensation	2,726	1,477
	6,215	3,394

17. SUPPLEMENTAL CASH FLOW INFORMATION

	December 31, 2021	December 31, 2020
	$	$
Change in non-cash operating working capital:		
Accounts receivable	(25,126)	(1,988)
Inventories	(173)	(269)
Prepaids and deposits	(41)	54
Accounts payable and accrued liabilities	19,080	1,276
Deferred share units liability	-	(295)
	(6,260)	(1,222)

Change in non-cash investing working capital:		
Accounts payable and accrued liabilities	29,785	1,451
	29,785	1,451
Interest received	$ 811	$ 947

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

a) Commodity price risk

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

The Company had the following outstanding financial derivative commodity contracts as at December 31, 2021:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT Basis (1) (2)	Differential	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$7.26/mmbtu
Natural Gas	AGT Basis (3)	Differential	Jan 1- Mar 31, 2022	2,500 mmbtu	Cdn$4.16/mmbtu
Natural Gas	NYMEX (4)	Fixed	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$3.85/mmbtu
Natural Gas	NYMEX	Fixed	Jan 1- Mar 31, 2022	2,500 mmbtu	Cdn$3.76/mmbtu
Natural Gas	AGT	Fixed	Jan 2022	2,500 mmbtu	Cdn$20.89/mmbtu
Natural Gas	AGT	Fixed	Jan 1- Feb 28, 2022	2,500 mmbtu	Cdn$25.27/mmbtu
Natural Gas	AGT	Fixed	Mar 2022	2,500 mmbtu	Cdn$11.07/mmbtu

(1) AGT = Algonquin city-gates
(2) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn$7.26/mmbtu
(3) Headwater pays on AGT while counterparty pays on NYMEX plus Cdn$4.16/mmbtu
(4) NYMEX = NYMEX Henry Hub

As security for certain financial derivative commodity contracts, the counterparty has the authority to hold Headwater funds in the amount of US$9.0 million. No funds were held at December 31, 2021 (December 31, 2020 – US$1.2 million).

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 has a demand debenture in the principal amount of $75 million providing for a floating charge over all assets of the Company. The risk management facility does not have any financial covenants that must be adhered to and the Company is in compliance with all other covenants.

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

	December 31, 2021	December 31, 2020
	$	$
Financial derivatives gains (losses):		
- realized gains	955	5,515
- unrealized financial derivative losses	(3,228)	(1,407)
Financial derivatives gains (losses)	(2,273)	4,108

The following table summarizes the fair value of the Company's financial derivative contracts as at December 31, 2021 and the change in fair value for the year:

	Commodity contracts	Foreign exchange contracts	Total
	$	$	$
Net financial derivative receivable, December 31, 2019	1,481	-	1,481
Unrealized change in fair value	(1,407)	-	(1,407)
Net financial derivative receivable, December 31, 2020	74	-	74
Unrealized change in fair value	(3,459)	231	(3,228)
Net financial derivative liability, December 31, 2021	(3,385)	231	(3,154)

For the Company's commodity contracts, the fair value of the net financial derivative liability of $3.4 million as at December 31, 2021 is based on estimated future natural gas prices as of that date. The fair values of these financial derivative commodity contracts are sensitive to changes in the natural gas reference prices. Holding other assumptions constant, if AGT prices increased (decreased) by 10%, the fair value of the financial derivative liability would increase (decrease) by $1.3 million.

Financial derivative receivables and liabilities are only offset if Headwater has the current legal right to offset and intends to settle on a net basis. The Company offsets when the counterparty, commodity, currency and timing of settlement are the same.

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

ii) Foreign currency risk

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

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

The Company had the following outstanding foreign exchange contract as at December 31, 2021:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, December 2021 average (1)	US$17,000,000	January 25, 2022

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

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

(thousands of U.S. dollars)	December 31, 2021	December 31, 2020
	$	$
Cash	535	7
Accounts receivable	20,272	1,031
Financial instruments in U.S. dollars	20,807	1,038

The majority of the Company's accounts receivable denominated in U.S. dollars in the table above has been hedged at the December 2021 average noon rate through the Company's outstanding foreign exchange contract mitigating exposure to foreign currency fluctuations. Had the Canadian dollar weakened to the U.S. dollar by 5% on December 31, 2021, the Company's net income before taxes for the year ended December 31, 2021 would be higher by $0.2 million. Had the Canadian dollar strengthened to the U.S. dollar by 5% on December 31, 2021, the Company's net income before taxes for the year ended December 31, 2021 would be lower by $0.2 million.

Fair Value Measurement

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

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

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

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

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

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

iii) Credit risk

As at December 31, 2021, the carrying amount of cash, restricted cash, accounts receivable, deposits and financial derivative receivable represent the Company's maximum credit exposure. The Company's cash and cash equivalents are held on deposit with Canadian chartered banks.

Headwater's receivables from its crude oil and natural gas sales are subject to normal credit risk. During the year ended December 31, 2021, the Company sold its crude oil and natural gas production to various counterparties with one counterparty accounting for 74% of sales (73% of accounts receivable as at December 31, 2021). 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 both counterparties occurs on the 25th day following the month of sale. As a result, the Company's production revenues are current.

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

At December 31, 2021, 100% of the Company's accounts receivables were outstanding for less than 30 days. The average expected credit loss on the Company's accounts receivable is 0% as at December 31, 2021.

Trade receivables generally have a 30-day term and have all been collected subsequent to year-end. As at December 31, 2021, the Company's receivables consisted of $30.1 million (December 31, 2020 - $5.0 million) from crude oil and natural gas marketers and commodity contract counterparties, $0.4 million (December 31, 2020 - $0.2 million) from its joint venture partner and $0.1 million (December 31, 2020 - $0.3 million) related to accrued interest and other.

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 and an actively managed operating and capital expenditure budgeting process. As at December 31, 2021, the Company was holding cash of $114.7 million.

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

	Within 1 year	1 to 5 years
	$	$
Accounts payable and accrued liabilities	52,970	-
Financial derivative liability	3,924	-
DSU liability	196	-
Lease liability	855	695
Total	57,945	695

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. To aid in managing the capital structure, the Company monitors adjusted working capital and adjusted funds flow from operations.

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. Key indicators of changing economic conditions include adjusted working capital and adjusted funds flow from operations. 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.

i) Adjusted working capital

Management considers adjusted working capital to be a key measure to assess the Company's liquidity and capital management.

	December 31, 2021	December 31, 2020
	$	$
Working capital	89,775	70,528
Financial derivative receivable	(770)	(74)
Financial derivative liability	3,924	-
Warrant liability	-	10,305
Adjusted working capital	92,929	80,759

ii) Adjusted funds flow from operations

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

	December 31, 2021	December 31, 2020
	$	$
Cash flows provided by operating activities	111,656	230
Changes in non-cash working capital	6,260	1,222
Transaction costs	-	7,330
Adjusted funds flow from operations	117,916	8,782

Adjusted working capital and adjusted funds flow from operations are not standardized measures and, therefore, may not be comparable with the calculation of similar measures of other entities.

The Company has not paid or declared any dividends.

19. RELATED PARTY TRANSACTIONS

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

	December 31, 2021	December 31, 2020
	$	$
Wages and benefits	2,798	2,304
Directors' compensation	-	610
Stock-based compensation	2,698	1,260
	5,496	4,174

Wages and benefits to key management personnel include salary, bonus and benefits accrued during the year. Stock-based compensation includes non-cash expenses accrued under the Company's Old Option Plan, New Option Plan and DSU plans for both key management personnel and directors of the Company.

20. COMMITMENTS

a) Commitments

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

	Total	2022	2023	2024	2025	2026	Thereafter
	$	$	$	$	$	$	$
Transportation (1) (2)	104,528	9,315	10,828	11,043	12,121	13,222	47,999

(1) Headwater has the following transportation commitments:
   a. 9- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
   b. 9- year financial commitment at $1,890 thousand per year adjusted for inflation.
   c. 9-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) Excludes leases accounted for under IFRS 16. Refer to note 8.

b) Letter of credit

As at December 31, 2021, the Company had a standby letter of credit issued by a Canadian chartered bank in the amount of $0.4 million relating to a transportation arrangement. The standby letter of credit is supported by cash and is recorded in restricted cash in the Statement of Financial Position.

21. SUBSEQUENT EVENTS

a) Awards Plan and DSU Plan

At the meeting of the Board of Directors held on March 10, 2022, the directors approved a new incentive awards plan (the “Awards Plan”) providing for the grant of RSUs and PSUs to officers, employees and consultants of the Company. The maximum number of common shares issuable under the Awards Plan shall not at any time exceed 6.0% of the total common shares outstanding less the aggregate number of common shares reserved for issuance pursuant to the New Option Plan and the Old Option Plan of the Company. Generally, one third of the RSUs will vest on each of the first, second and third anniversaries of the date of grant and all PSUs will vest on the third anniversary of the date of grant, unless otherwise determined by the Board of Directors. The common shares underlying PSUs are adjusted based on a payout multiplier ranging from 0 to 2 times, which is determined based on certain corporate performance measures, as determined by the Board of Directors.

Until the Company receives approval of the Awards Plan from the shareholders of the Company in accordance with the rules of the TSX, the Company will not be able to issue common shares on settlement of RSUs and PSUs and will instead be required to make a cash payment equal to the value of the common shares underlying the applicable RSUs or PSUs.

At the meeting of the Board of Directors held on March 10, 2022, the directors approved the adoption of the new DSU plan (the “DSU Plan”). The DSU Plan provides for grants of DSUs to non-management directors. Each DSU vests on the date of grant; however, settlement of the DSU occurs when the individual ceases to be a director of the Company. DSUs are to be settled in cash or by payment in common shares acquired through the facilities of the TSX. The directors may also elect to receive all of their annual cash compensation in the form of DSUs provided that such election must be made on December 1st of the preceding calendar year (or within a certain prescribed time frame if an individual becomes a director after the commencement of a calendar year or after the initial adoption of the DSU Plan) and after such date the election will be irrevocable for such year. DSUs are measured at fair value using the 5-day volume weighted average price on the date of grant.

b) Financial derivative commodity contracts and foreign exchange contracts

Subsequent to December 31, 2021, Headwater entered into the following commodity contracts:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT	Fixed	Feb 2022	5,000 mmbtu/d	Cdn$20.17/mmbtu
Natural Gas	AGT	Fixed	March 2022	2,500 mmbtu/d	Cdn$11.73/mmbtu
Natural Gas	AGT	Fixed	April 2022	5,000 mmbtu/d	Cdn$6.48//mmbtu
Natural Gas	AGT	Fixed	Dec 2022- Mar 2023	2,500 mmbtu/d	Cdn$17.91/mmbtu

Subsequent to December 31, 2021, Headwater entered into the following foreign exchange contracts:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, January 2022 average	US$30,100,000	February 25, 2022
Forward contract	CAD	USD	WMR noon rate, February 2022 average	US$29,600,000	March 25, 2022
Forward contract	CAD	USD	WMR noon rate, March 2022 average	US$40,300,000	April 25, 2022