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

(Cdn$ thousands)	June 30, 2022	December 31, 2021
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	144,836	114,703
Restricted cash (note 12)	5,350	350
Accounts receivable (note 12)	50,072	30,601
Contribution receivable (note 6)	6,041	-
Financial derivative receivable (note 12)	130	770
Inventories	1,616	807
Prepaids and deposits	970	489
Total current assets	209,015	147,720
Contribution receivable (note 6)	671	-
Exploration and evaluation assets (note 3)	55,247	28,993
Property, plant and equipment (note 4)	359,180	310,290
Right-of-use assets	1,231	1,469
Other assets	335	335
Total assets	625,679	488,807
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (note 12)	62,434	52,970
Deferred share units liability (note 8)	685	196
Financial derivative liability (note 12)	6,696	3,924
Current portion of lease liability	790	855
Current income tax liability	11,309	-
Total current liabilities	81,914	57,945
Lease liability	491	695
Decommissioning liability (note 5)	25,384	27,600
Repayable contribution (note 6)	4,132	-
Deferred income tax liability	21,613	4,776
Total liabilities	133,534	91,016
Shareholders' Equity		
Capital stock (note 7)	476,622	469,521
Warrants (note 7)	1,233	5,437
Contributed surplus	15,368	14,686
Deficit	(1,078)	(91,853)
Total shareholders' equity	492,145	397,791
Total liabilities and shareholders' equity	625,679	488,807

Commitments (note 13), Subsequent events (note 14)

See accompanying notes to the interim condensed financial statements

Approved on behalf of the Board of Directors:

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

(signed) "Neil Roszell"
Neil Roszell
Chairman

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

	Three months ended June 30,		Six months ended June 30,	
	2022	2021	2022	2021
(Cdn$ thousands, except per share data)	$	$	$	$
REVENUE				
Sales (note 9)	130,153	40,038	249,415	65,530
Royalties	(25,404)	(5,351)	(42,242)	(7,706)
Revenue, net of royalties	104,749	34,687	207,173	57,824
Losses on financial derivatives (note 12)	(3,059)	(1,312)	(7,134)	(2,117)
	101,690	33,375	200,039	55,707
EXPENSES				
Blending and transportation	12,384	7,579	27,095	12,538
Production	6,030	2,960	12,466	5,373
General and administrative	1,624	971	3,274	1,818
Remeasurement loss on warrant liability	-	5,973	-	25,168
Stock-based compensation (note 8)	1,399	610	2,098	1,130
Depletion and depreciation (note 4)	17,243	10,459	36,281	17,709
	38,680	28,552	81,214	63,736
Interest income and other expense (note 10)	361	(235)	96	(176)
Income (loss) before income taxes	63,371	4,588	118,921	(8,205)
Income taxes				
Current income tax expense	5,493	-	11,309	-
Deferred income tax expense	9,466	-	16,837	-
Net income (loss) and comprehensive income (loss)	**48,412**	**4,588**	**90,775**	**(8,205)**
Net income (loss) per share (note 7)				
Basic	0.21	0.02	0.41	(0.04)
Diluted	0.21	0.02	0.39	(0.04)

See accompanying notes to the interim condensed financial statements

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

Cash flow related to the following activities:	Three months ended June 30, 2022	Three months ended June 30, 2021	Six months ended June 30, 2022	Six months ended June 30, 2021
(Cdn$ thousands)	$	$	$	$
OPERATING				
Net income (loss)	48,412	4,588	90,775	(8,205)
Items not involving cash:				
Unrealized losses on financial derivatives (note 12)	2,801	1,458	2,931	1,712
Remeasurement loss on warrant liability	-	5,973	-	25,168
Stock-based compensation	1,399	610	2,098	1,130
Depletion and depreciation	17,243	10,459	36,281	17,709
Income tax expense	14,959	-	28,146	-
Non-cash finance charges (note 10)	114	94	536	147
Change in non-cash operating working capital (note 11)	(200)	50	(15,350)	(1,646)
Cash flows provided by operating activities	84,728	23,232	145,417	36,015
FINANCING				
Payment of lease liability	(230)	(36)	(462)	(72)
Proceeds from exercise of stock options & warrants (note 7)	1,198	5,163	1,215	5,547
Cash flows provided by financing activities	968	5,127	753	5,475
INVESTING				
Capital expenditures – property, plant and equipment (note 4)	(27,656)	(16,305)	(71,349)	(53,299)
Capital expenditures – exploration and evaluation (note 3)	(5,795)	(476)	(44,059)	(754)
Change in restricted cash	-	240	(5,000)	1,477
Change in non-cash investing working capital (note 11)	(2,212)	(13,538)	4,371	14,237
Cash flows used in investing activities	(35,663)	(30,079)	(116,037)	(38,339)
Change in cash and cash equivalents	50,033	(1,720)	30,133	3,151
Cash and cash equivalents, beginning of period	94,803	81,643	114,703	76,772
Cash and cash equivalents, end of period	144,836	79,923	144,836	79,923

See accompanying notes to the interim condensed financial statements

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

(Cdn$ thousands)	Note	Capital stock $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' equity $
Balance at January 1, 2021		**387,393**	**7,659**	**11,659**	**(137,681)**	**269,030**
Exercise of stock options		801	-	(783)	-	18
Exercise of warrants		7,676	(2,147)	-	-	5,529
Stock-based compensation		-	-	1,819	-	1,819
Net loss		-	-	-	(8,205)	(8,205)
Balance at June 30, 2021		**395,870**	**5,512**	**12,695**	**(145,886)**	**268,191**
Balance at January 1, 2022		**469,521**	**5,437**	**14,686**	**(91,853)**	**397,791**
Exercise of stock options	7	2,462	-	(1,682)	-	780
Exercise of warrants	7	4,639	(4,204)	-	-	435
Stock-based compensation		-	-	2,364	-	2,364
Net income		-	-	-	90,775	90,775
Balance at June 30, 2022		**476,622**	**1,233**	**15,368**	**(1,078)**	**492,145**

See accompanying notes to the interim condensed financial statements

1. NATURE OF OPERATIONS

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".

Headwater's principal place of business is located at 1400, 215 – 9th Avenue S.W., Calgary, Alberta, T2P 1K3 and its registered office is located at 2400, 525 – 8th Avenue S.W., Calgary, Alberta, T2P 1G1.

2. BASIS OF PREPARATION

These unaudited interim condensed financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), and in accordance with IAS 34 – *Interim Financial Reporting*. The unaudited interim condensed financial statements do not include all information required for annual financial statements and should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2021. These unaudited interim condensed financial statements have been prepared following the same accounting policies as the Company's audited financial statements for the year ended December 31, 2021, except for the below.

During the six months ended June 30, 2022, the Company recorded current income tax expense in accordance with IAS 12 – *Income taxes*. Current income tax expense is the expected taxes payable on taxable income for the period, using tax rates enacted or substantively enacted at the reporting date.

During the six months ended June 30, 2022, the Company received confirmation from the Department of Natural Resources Canada ("NRCan") of payment of funds for the Company's first claim made in relation to a repayable contribution agreement under the Emissions Reduction Fund ("ERF") Onshore Program. The funds are partially repayable and have been recognized as contribution receivable and repayable contribution in the statement of financial position. The Company has followed IAS 20 – *Accounting for government grants* to account for this transaction. See note 6.

During the six months ended June 30, 2022, the Company granted restricted share units ("RSUs") and performance share units ("PSUs") under a new incentive awards plan (the "Awards Plan") approved by the shareholders of the Company on May 12, 2022. The Company has accounted for these grants as equity settled share-based awards following guidance in IFRS 2 – *Share-based payment.* See note 8.

The timely preparation of these financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amount of assets, liabilities, income and expenses. Actual results may differ materially from these estimates. Significant judgments, estimates and assumptions made by management in these financial statements are outlined in the audited financial statements for the year ended December 31, 2021.

These unaudited interim condensed financial statements were approved and authorized for issue by the Company's Board of Directors on August 4, 2022.

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

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

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

	June 30, 2022	December 31, 2021
	$	$
Balance, beginning of period	28,993	27,101
Additions	44,059	14,409
Transfers to PP&E	(17,805)	(12,517)
Balance, end of period	55,247	28,993

The Company concluded there are no indicators of impairment for its E&E assets as at June 30, 2022.

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

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

	Oil and gas properties	Corporate	Total
Cost	$	$	$
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
Additions (1)	72,101	5	72,106
Transfers from E&E	17,805	-	17,805
Government grant (note 6)	(2,591)	-	(2,591)
Changes in decommissioning liabilities	(2,499)	-	(2,499)
Balance at June 30, 2022	683,940	2,757	686,697
Accumulated depletion, depreciation and impairment			
Balance at December 31, 2020	261,645	2,151	263,796
Depletion and depreciation expense	44,007	76	44,083
Impairment reversal	(16,293)	-	(16,293)
Balance at December 31, 2021	289,359	2,227	291,586
Depletion and depreciation expense	35,898	33	35,931
Balance at June 30, 2022	325,257	2,260	327,517
Net book value at December 31, 2021	309,765	525	310,290
Net book value at June 30, 2022	358,683	497	359,180

(1) Includes capitalized general and administrative expenses of $1.8 million and capitalized stock-based compensation of $0.8 million.

The Company concluded there are no indicators of impairment for its CGUs as at June 30, 2022.

5. DECOMMISSIONING LIABILITY

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

	June 30, 2022	December 31, 2021
	$	$
Balance, beginning of period	27,600	16,718
Additions	5,929	10,772
Change in estimate (1)	(8,428)	(231)
Accretion	283	341
Balance, end of period	25,384	27,600

(1) Change in estimate relates to an increase in the risk-free rate from 1.7% at December 31, 2021 to 3.1% at June 30, 2022.

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

The Company has estimated the net present value of its total decommissioning liabilities to be $25.4 million as at June 30, 2022 (December 31, 2021 - $27.6 million). The total future inflated and undiscounted amount of estimated cash flows required to settle these obligations is $48.8 million (December 31, 2021 - $40.7 million). Management estimates the settlement of these obligations will occur over the next 16 to 32 years. At June 30, 2022, a risk-free rate of 3.1% (December 31, 2021 – 1.7%) and an inflation rate of 1.8% (December 31, 2021 – 1.8%) were used to calculate the estimated fair value of the decommissioning liability.

6. REPAYABLE CONTRIBUTION (NRCan ERF)

During the three months ended June 30, 2022, the Company received approval of its first claim pursuant to a repayable contribution agreement with NRCan, under the ERF Onshore Program. NRCan will provide financial assistance by way of a partially repayable interest-free loan to the Company for its working interest in the joint Marten Hills natural gas processing plant and gathering system, as well as for gas conservation equipment associated with the Company's wholly owned oil processing facility in Marten Hills (the "Project"). Headwater will repay 80% of the financial assistance pursuant to the terms and conditions of the agreement, with the remaining 20% being non-repayable. The Project eliminates venting and flaring of methane rich natural gas from existing and future oil wells in the Company's core area of Marten Hills.

Over the course of the Project, NRCan will contribute the lesser of 75% of total eligible Project costs and $18.5 million. The repayable portion of the funds received are to be repaid as follows: 10% on March 31, 2025, 33% on March 31, 2026, and 57% on March 31, 2027.

Headwater accounts for the non-repayable portion and benefit of the interest-free period of the financial assistance as a government grant. Government grants are recognized when there is reasonable assurance that the grant will be received, and all conditions associated with the grant are met. As this grant relates to the Company's PP&E, the grant is recorded as a reduction to the asset's carrying amount and is depreciated over the useful life of the asset. The Company recognized $2.6 million as an offset against PP&E for the three and six months ended June 30, 2022.

The Company has been approved for eligible expenditures incurred to September 30, 2021. The ERF will retain a 10% holdback from each payment until the Company has filed its first annual outcome report. The 10% holdback has been recorded as a long-term receivable within the statement of financial position. The first claim reimbursement amount, net of the holdback, of $6.0 million was received subsequent to June 30, 2022.

The Company has recognized a repayable contribution of $5.4 million, undiscounted, and $4.1 million discounted as at June 30, 2022 with respect to claims submitted to the ERF and confirmed by NRCan. The Company discounts the repayable contribution at a market interest rate of 6.5%.

	June 30, 2022
	$
Balance, beginning of period	-
Repayable contribution discounted at 6.5%	4,121
Interest	11
Balance, end of period	4,132

The Company is in compliance with all terms and conditions of the repayable contribution agreement.

7. CAPITAL STOCK

a) Issued and outstanding

	June 30, 2022		December 31, 2021	
	Number of shares	Amount	Number of shares	Amount
		$		$
Balance, beginning of period	217,681	469,521	195,106	387,393
Deferred income taxes on share issue costs	-	-	-	288
Exercise of warrants by Cenovus	-	-	15,000	72,904
Exercise of stock options	1,774	2,462	1,299	990
Exercise of warrants	10,453	4,639	6,276	7,946
Balance, end of period	229,908	476,622	217,681	469,521

Stock Options

During the six months ended June 30, 2022, 2.3 million stock options were exercised for 1.8 million common shares and cash proceeds of $0.8 million. Contributed surplus related to the stock options exercised of $1.7 million was transferred to capital stock.

Warrants

During the six months ended June 30, 2022, 11.9 million warrants were exercised for 10.5 million common shares and cash proceeds of $0.4 million. The associated fair value of the warrants of $4.2 million was transferred to capital stock.

b) Warrants

	June 30, 2022		December 31, 2021	
	Number of warrants	Amount	Number of warrants	Amount
		$		$
Balance, beginning of period	15,387	5,437	21,677	7,659
Exercise of warrants	(11,900)	(4,204)	(6,290)	(2,222)
Balance, end of period	3,487	1,233	15,387	5,437

As at June 30, 2022, there were 3.5 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.

c) Per share amounts

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

	Three months ended June 30,		Six months ended June 30,	
	2022	2021	2022	2021
Weighted average shares outstanding				
Basic	226,168	197,445	223,702	196,389
Diluted	233,479	213,905	230,957	196,389

As the Company incurred a net loss for the six months ended June 30, 2021, in computing the diluted net loss per share, the effect of stock options and warrants were excluded as they were anti-dilutive.

8. STOCK-BASED COMPENSATION

a) Stock options

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

	Six months ended June 30, 2022		Year ended December 31, 2021	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	9,505	$ 2.36	7,978	$ 1.32
Granted	-	-	3,430	$ 4.22
Forfeited, cancelled or expired	-	-	(160)	$ 2.87
Exercised (1)	(2,287)	$ 1.90	(1,743)	$ 1.18
Options outstanding, end of period	7,218	$ 2.51	9,505	$ 2.36
Options exercisable, end of period	1,799	$ 1.92	1,083	$ 1.45

(1) The Company's weighted average share price, at the date of exercise, for stock options exercised during the six months ended June 30, 2022 was $6.94 per common share.

The range of exercise prices of stock options outstanding and exercisable as at June 30, 2022 is as follows:

	Outstanding options			Exercisable options	
Exercise prices	Number of options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$ 0.72 - $ 1.00	225	1.72	$ 0.97	25	$ 0.72
$ 1.01 - $ 2.00	3,078	1.74	$ 1.06	1,262	$ 1.06
$ 2.01 - $ 3.00	1,580	2.48	$ 2.50	133	$ 2.45
$ 3.01 - $ 5.23	2,335	2.79	$ 4.58	379	$ 4.66
Total	7,218	2.24	$ 2.51	1,799	$ 1.92

For the six months ended June 30, 2022, the Company recorded gross stock-based compensation expense of $1.6 million and capitalized stock-based compensation expense of $0.5 million for stock options outstanding.

b) Deferred share units ("DSUs")

At the meeting of the Board of Directors held on March 10, 2022, the directors approved the adoption of a 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. It is the intention of the Company to settle DSUs in cash.

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

	June 30, 2022		December 31, 2021	
	Number of DSUs	Amount	Number of DSUs	Amount
		$		$
DSUs, beginning of period	38	196	38	91
Granted	81	568	-	-
Fair value adjustment during the period	-	(79)	-	105
DSUs, end of period	119	685	38	196

The DSU liability as at June 30, 2022 of $0.7 million is based on a fair value of $5.76 per DSU which is the Company's five-day volume weighted average trading price on June 30, 2022.

c) Share awards

At the meeting of the Board of Directors held on March 10, 2022, the directors approved the Awards Plan providing for the grant of RSUs and PSUs (the "Awards") to officers, employees and consultants of the Company. Under the Awards Plan, the aggregate number of common shares reserved for issuance may not exceed the lesser of: (i) 6.0% of the aggregate number of issued and outstanding common shares less the aggregate number of common shares reserved for issuance under the Company's stock option plans; and (ii) 4.5% of the aggregate number of issued and outstanding common shares. 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. The Company received approval of the Awards Plan from the shareholders of the Company on May 12, 2022.

The Awards Plan allows a holder to receive common shares upon vesting. Headwater uses the fair value method for valuing Awards. The fair value of Awards is determined based on the volume weighted average trading price of the five days preceding the grant date. This fair value is recognized as stock-based compensation expense over the vesting period with a corresponding increase to contributed surplus. The amount of stock-based compensation expense is reduced by an estimated forfeiture rate determined at the date of the grant and updated each period. Upon vesting of the Awards and settlement in common shares, the previously recognized value in contributed surplus will be recorded as an increase to capital stock.

The following table summarizes the changes in Awards for the three and six months ended June 30, 2022:

	RSUs	PSUs
Outstanding, beginning of period	-	-
Granted	153,540	818,460
Outstanding, end of period	153,540	818,460

For the six months ended June 30, 2022, the Company recorded gross stock-based compensation expense of $0.8 million and capitalized stock-based compensation expense of $0.3 million for the Awards outstanding.

9. SALES

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

	Three months ended June 30, 2022	Three months ended June 30, 2021	Six months ended June 30, 2022	Six months ended June 30, 2021
	$	$	$	$
Heavy oil	124,919	39,257	228,292	58,412
Natural gas	4,249	566	19,501	6,284
Gathering, processing and transportation	308	184	875	772
Natural gas liquids	677	31	747	62
	130,153	40,038	249,415	65,530

Included in accounts receivable as at June 30, 2022 is $49.9 million (December 31, 2021 - $28.2 million) of accrued sales related to June 2022 production.

10. INTEREST INCOME AND OTHER EXPENSE

Interest income and other expense consists of the following:

	Three months ended June 30, 2022	Three months ended June 30, 2021	Six months ended June 30, 2022	Six months ended June 30, 2021
	$	$	$	$
Interest income	496	146	733	350
Realized and unrealized foreign exchange gains (losses)	60	(287)	(309)	(379)
Accretion on decommissioning liability	(168)	(89)	(283)	(139)
Interest on repayable contribution	(11)	-	(11)	-
Interest on lease liability	(16)	(5)	(34)	(8)
	361	(235)	96	(176)

(1) Included within non-cash finance charges in the statement of cash flows is unrealized foreign exchange gains (losses), accretion on decommissioning liability, interest on repayable contribution and interest on lease liability.

11. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended June 30, 2022	Three months ended June 30, 2021	Six months ended June 30, 2022	Six months ended June 30, 2021
	$	$	$	$
Change in non-cash operating working capital:				
Accounts receivable	447	(2,434)	(19,198)	(10,169)
Inventories	1,403	117	(764)	247
Prepaids and deposits	(312)	(163)	(481)	(202)
Accounts payable and accrued liabilities	(1,738)	2,530	5,093	8,478
	(200)	50	(15,350)	(1,646)
Change in non-cash investing working capital:				
Accounts payable and accrued liabilities	(2,212)	(13,538)	4,371	14,237
	(2,212)	(13,538)	4,371	14,237

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

a) The Company is exposed to the following risks:

i) Commodity price risk

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

The Company had the following outstanding financial derivative commodity contracts as at June 30, 2022:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT [(1)]	Fixed	Dec 2022- Mar 2023	2,500 mmbtu	Cdn$17.91/mmbtu
Natural Gas	AGT	Fixed	Jan 2023- Feb 2023	2,500 mmbtu	Cdn$32.71/mmbtu
Crude Oil	WCS Basis [(2)]	Differential	Oct 2022- Dec 2022	1,000 bbls	US$15.75/bbl

(1) AGT = Algonquin city-gates
(2) WCS = Western Canadian Select

As security for certain financial derivative commodity contracts, the Company posted $5.0 million to the counterparty as collateral which is recorded in restricted cash.

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

Financial derivatives

The following table summarizes the Company's financial derivative losses on commodity contracts for the periods:

	Three months ended June 30,		Six months ended June 30,	
	2022	2021	2022	2021
	$	$	$	$
Losses on financial derivatives:				
- realized gains (losses)	(258)	146	(4,203)	(405)
- unrealized losses	(2,801)	(1,458)	(2,931)	(1,712)
Losses on financial derivatives	(3,059)	(1,312)	(7,134)	(2,117)

The following table summarizes the fair value as at June 30, 2022 and the change in fair value for the six months ended June 30, 2022:

	Commodity contracts	Foreign exchange contracts	Total
	$	$	$
Net financial derivative receivable/liability, beginning of period	(3,385)	231	(3,154)
Unrealized change in fair value (1)	(2,931)	(481)	(3,412)
Net financial derivative receivable/liability, end of period	(6,316)	(250)	(6,566)

(1) Unrealized change in fair value related to the Company's foreign exchange contracts is included in interest income and other expense.

The fair value of the net financial derivative liability related to the Company's commodity contracts of $6.3 million as at June 30, 2022 is based on estimated future natural gas and crude oil prices as of that date. The fair values of these financial derivative commodity contracts are sensitive to changes in the natural gas and crude oil reference prices. Holding other assumptions constant, if AGT and WCS prices increased (decreased) by 10%, the fair value of the financial derivative liability would increase (decrease) by $1.9 million.

ii) Foreign currency risk

The Company is exposed to fluctuations of the Canadian to U.S. dollar exchange rate given realized pricing is directly influenced by U.S. dollar denominated benchmark pricing and from exposure to its U.S. dollar denominated heavy oil and natural gas marketing arrangements. At June 30, 2022, US$0.9 million (December 31, 2021- US$0.5 million) of cash and US$38.0 million (December 31, 2021- $20.3 million) of accounts receivable were denominated in U.S. dollars.

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 June 30, 2022:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	USD	CAD	June 2022 average (1)	US$42.0 million	July 26, 2022

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

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 of cash and cash equivalents, restricted cash, accounts receivable, contribution receivable, deposits, accounts payable and accrued liabilities and current income tax liability approximate their carrying value due to the short term to maturity of these instruments. The repayable contribution has been discounted at a market interest rate and therefore carrying value approximates fair value.

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

iii) Credit risk

At June 30, 2022, 100% of the Company's accounts receivable were outstanding for less than 30 days. Trade receivables generally have a 30-day term and have all been collected subsequent to June 30, 2022. As at June 30, 2022, the Company's accounts receivable consisted of $49.9 million (December 31, 2021 - $28.2 million) from crude oil and natural gas marketers, $0.1 million (December 31, 2021 - $0.4 million) from its joint venture partner and $0.1 million (December 31, 2021 - $2.0 million) related to accrued interest and other.

The contribution receivable of $6.0 million is outstanding from the Government of Canada and has been collected subsequent to June 30, 2022.

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.

	As at June 30, 2022	As at December 31, 2021
	$	$
Working capital	127,101	89,775
Contribution receivable (long-term)	671	-
Repayable contribution	(4,132)	-
Financial derivative receivable	(130)	(770)
Financial derivative liability	6,696	3,924
Adjusted working capital	130,206	92,929

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 flow 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 deducting current income taxes, 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. While current income taxes will not be paid until 2023, management believes adjusting for current income taxes in the period incurred is a better indication of the funds generated by the Company.

	Three months ended June 30,		Six months ended June 30,	
	2022	2021	2022	2021
	$	$	$	$
Cash flows provided by operating activities	84,728	23,232	145,417	36,015
Changes in non-cash working capital	200	(50)	15,350	1,646
Current income taxes	(5,493)	-	(11,309)	-
Adjusted funds flow from operations	79,435	23,182	149,458	37,661

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.

13. COMMITMENTS

As at June 30, 2022, the Company is committed to future payments under the following agreements:

	Total	2022	2023	2024	2025	2026	Thereafter
	$	$	$	$	$	$	$
Transportation (1)	113,568	4,893	11,437	13,165	13,427	14,571	56,075
Lease (2)	765	-	357	375	33	-	-
Government grant (3)	5,370	-	-	-	537	1,788	3,045
Total	119,703	4,893	11,794	13,540	13,997	16,359	59,120

(1) At June 30, 2022, 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 $1.9 million per year adjusted for inflation.
   c. 9- year take-or-pay transportation agreement with a current minimum volume commitment of 4,750 boe/d increasing to 9,750 boe/d in year 3 and to 12,500 boe/d in year 6.

(2) Relates to variable operating costs, which are a non-lease component of the Company's head office lease.

(3) Relates to scheduled re-payments of federal government funding under the terms of the repayable contribution agreement with NRCan. See note 6.

(4) Excludes leases accounted for under IFRS 16.

14. SUBSEQUENT EVENTS

Foreign Exchange Contracts

Subsequent to June 30, 2022, Headwater entered into the following foreign exchange contracts:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	USD	CAD	July 2022 average	US$28.0 million	August 26, 2022
Forward contract	USD	CAD	August 2022 average	US$25.0 million	September 27, 2022