2023 Management's Discussion and Analysis

The following management's discussion and analysis ("MD&A") as provided by the management of Headwater Exploration Inc. ("Headwater" or the "Company") is dated March 7, 2024 and should be read in conjunction with the audited annual financial statements for the years ended December 31, 2023 and 2022 and the notes thereto. The audited annual financial statements have been prepared in accordance with IFRS Accounting Standards as issued by the International Accounting Standards Board ("IFRS"). All dollar amounts are referenced in Canadian dollars unless otherwise stated. In addition, readers are also directed to the Company's Annual Information Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at www.headwaterexp.com and through SEDAR+ at www.sedarplus.ca.

Description of the Company

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

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

FOURTH QUARTER 2023 HIGHLIGHTS

- Achieved record average production of 19,939 boe/d (consisting of 18,514 bbls/d of heavy oil, 8.0 mmcf/d of natural gas and 93 bbls/d of natural gas liquids), an increase of 28% over 2022 fourth quarter production of 15,546 boe/d (1).

- Realized record adjusted funds flow from operations (2) of $82.0 million ($0.35 per basic share (3)), cash flows from operating activities of $90.7 million ($0.38 per basic share) and free cash flow (4) of $51.9 million.

- Achieved an operating netback, including financial derivatives, (3) of $49.07/boe and an adjusted funds flow netback (3) of $44.26/boe.

- Generated net income of $45.5 million ($0.19 per basic share) equating to $24.55/boe.

- Executed a $30.1 million capital expenditure (4) program including 13 net crude oil wells in Marten Hills West, at a 100% success rate.

- Returned $0.10 per common share to shareholders.

- As at December 31, 2023, Headwater had working capital of $78.6 million, adjusted working capital (2) of $63.5 million and no outstanding bank debt.

YEAR ENDED DECEMBER 31, 2023 HIGHLIGHTS

- Returned a total of $0.40 per common share or $94.4 million to shareholders.

- Achieved average production of 18,038 boe/d (consisting of 16,466 bbls/d of heavy oil, 8.8 mmcf/d of natural gas and 98 bbls/d of natural gas liquids), an increase of 40% over 2022 annual production of 12,841 boe/d (1).

- Realized adjusted funds flow from operations (2) of $288.3 million ($1.22 per basic share (3)) and cash flows from operating activities of $303.3 million ($1.29 per basic share).

- Achieved an operating netback, including financial derivatives, (3) of $49.95/boe and an adjusted funds flow netback (3) of $43.78/boe.

- Generated net income of $156.1 million ($0.66 per basic share) equating to $23.71/boe.

- Executed a $233.8 million capital expenditure (4) program:

  - Drilled 71 net crude oil wells in Marten Hills West, at a 100% success rate, establishing Marten Hills West as the Company's largest producing area with production levels exceeding 10,500 bbls/d in the fourth quarter;
  - Drilled two successful Stingwray wells in Seal and Marten Hills West proving a new technology to increase reservoir exposure;
  - Brought 2.5 sections within Marten Hills Core and a pilot section within Marten Hills West under secondary recovery resulting in oil rate stabilization and reduced gas-oil-ratios; and
  - Headwater continued its pursuit of organic growth opportunities in and beyond the boundaries of the Clearwater acreage adding 198 net sections to the Corporation's land base in 2023.

- Executed a successful hedging strategy realizing $14.1 million in total hedging gains primarily related to natural gas hedging gains in McCully, validating Headwater's strategy of opportunistic hedging in this highly volatile gas market.

- Entered into an agreement to construct natural gas tie-in infrastructure in Marten Hills West. Once the $22.5 million project is completed, Headwater will be reimbursed for the construction costs and enter into a long-term take-or-pay contract. The project will allow the Company to conserve a meaningful amount of its natural gas production in the area aligning with the Company's environment, social and governance ("ESG") strategy and significantly reducing Headwater's future carbon tax obligations.

(1) 2022 fourth quarter production consisted of 13,536 bbls/d heavy oil, 11.5 mmcf/d natural gas and 99 bbls/d natural gas liquids. 2022 annual production consisted of 11,411 bbls/d heavy oil, 8.2 mmcf/d natural gas and 57 bbls/d natural gas liquids.

(2) Capital management measure that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.

(3) Non-GAAP ratio that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

(4) Non-GAAP financial measure that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

Results of Operations

Production and Pricing

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
Average daily production						
Heavy oil (bbls/d)	18,514	13,536	37	16,466	11,411	44
Natural gas (mmcf/d)	8.0	11.5	(30)	8.8	8.2	7
Natural gas liquids (bbls/d)	93	99	(6)	98	57	72
Barrels of oil equivalent (boe/d)	19,939	15,546	28	18,038	12,841	40
Average daily sales (boe/d) (1)						
Heavy oil (bbls/d)	18,709	13,558	38	16,465	11,413	44
Natural gas (mmcf/d)	8.0	11.5	(30)	8.8	8.2	7
Natural gas liquids (bbls/d)	93	99	(6)	98	57	72
Barrels of oil equivalent (boe/d)	20,134	15,568	29	18,038	12,843	40
Headwater average sales price (2)						
Heavy oil ($/bbl) (3)	74.69	73.10	2	77.67	94.79	(18)
Natural gas ($/mcf)	3.00	10.15	(70)	3.69	10.60	(65)
Natural gas liquids ($/bbl)	73.53	73.02	1	75.78	91.29	(17)
Barrels of oil equivalent ($/boe)	70.94	71.60	(1)	73.12	91.44	(20)
Average Benchmark Price						
WTI (US$/bbl) (4)	78.32	82.64	(5)	77.62	94.23	(18)
WCS differential to WTI (US$/bbl)	(21.89)	(25.66)	(15)	(18.67)	(18.22)	2
WCS (Cdn$/bbl) (5)	76.96	77.42	(1)	79.56	98.52	(19)
Condensate at Edmonton (Cdn$/bbl)	102.83	111.82	(8)	102.11	123.20	(17)
AGT (US$/mmbtu) (6)	3.23	9.90	(67)	4.10	11.21	(63)
AECO 5A (Cdn$/GJ)	2.18	4.85	(55)	2.50	5.06	(51)
NYMEX Henry Hub (US$/mmbtu)	2.88	6.26	(54)	2.74	6.64	(59)
Exchange rate (Cdn$/US$)	0.73	0.74	(1)	0.74	0.77	(4)

(1) Includes sales of heavy crude oil excluding the impact of purchased condensate and butane. The Company's heavy oil sales volumes and production volumes differ due to changes in inventory.
(2) Average sales prices are calculated using average sales volumes.
(3) Realized heavy oil prices are based on sales, net of blending expense.
(4) WTI = West Texas Intermediate
(5) WCS = Western Canadian Select
(6) AGT = Algonquin city-gates. The AGT price is the average for the winter producing months in the McCully field which include January – April, November and December.

Sales

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Heavy oil sales	135,302	97,584	39	495,177	423,211	17
Blending expense	(6,736)	(6,403)	5	(28,411)	(28,332)	-
Heavy oil, net of blending (1)	128,566	91,181	41	466,766	394,879	18
Natural gas	2,207	10,706	(79)	11,921	31,876	(63)
Natural gas liquids	626	662	(5)	2,723	1,891	44
Gathering, processing and transportation	291	425	(32)	1,413	1,401	1
Total sales, net of blending expense (1)	131,690	102,974	28	482,823	430,047	12

(1) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

Heavy Oil – Alberta

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

WTI pricing trended lower during the year ended December 31, 2023, due to global recessionary risks, while the year ended December 31, 2022, saw a price risk premium due to international energy supply concerns associated with the Russia-Ukraine war. WTI pricing experienced some recovery in the third quarter of 2023 due to OPEC+ production cuts, but then pulled back in the fourth quarter of 2023 due to concerns related to market oversupply.

The WCS differential to WTI averaged comparably year over year, while the differential widened into the fourth quarter, from the first nine months of 2023, due to record supply out of Western Canada, pipeline apportionment and mild winter weather. Weaker WCS pricing is expected into 2024 until commissioning of the Trans Mountain pipeline expansion, which is anticipated to improve egress optionality for heavy crude oil out of Western Canada.

During the three months ended December 31, 2023, Headwater's heavy oil sales, net of blending expense, significantly increased to $128.6 million from $91.2 million in the corresponding period of the prior year. This increase was attributable to a 38% increase in heavy oil sales volumes, with commodity pricing remaining flat as lower WTI pricing was offset by a weaker Canadian dollar and the narrowing of the WCS differential to WTI in the quarter. During the year ended December 31, 2023, Headwater's heavy oil sales, net of blending expense, increased to $466.8 million from $394.9 million in the prior year. This increase was attributable to a 44% increase in heavy oil sales volumes, partially offset by an 18% decrease in realized commodity pricing, consistent with the decrease in benchmark WCS pricing.

For the three months and year ended December 31, 2023, Headwater's discount to WCS improved to $2.27/bbl and $1.89/bbl, respectively, from $4.32/bbl and $3.73/bbl, in the corresponding periods of 2022, due to blending optimization and stronger realized pricing relative to WCS.

During the three months and year ended December 31, 2023, Headwater's heavy oil sales volumes averaged 18,709 bbls/d and 16,465 bbls/d, respectively, compared to 13,558 bbls/d and 11,413 bbls/d in the corresponding periods of 2022. The Company's heavy oil sales volumes have increased significantly as a result of Headwater's extensive 2022 and 2023 capital expenditure programs. Headwater drilled 90.0 total net crude oil wells during the year ended December 31, 2023, and drilled 97.0 total net crude oil wells during the year ended December 31, 2022, substantially increasing the Company's heavy oil production.

Natural Gas – New Brunswick and Alberta

The Company produces natural gas out of the McCully field in New Brunswick. The transaction price is based on the AGT daily benchmark price adjusted for delivery location and heat content. Headwater also produces natural gas in Alberta, as the Company commissioned its Marten Hills joint gas processing facility and started generating sales from its associated natural gas production in the third quarter of 2021. The natural gas sales transaction price is based on the AECO 5A daily benchmark price adjusted for delivery location and heat content.

Both AGT and AECO 5A saw a significant decrease in pricing year over year due to increasing storage levels resulting from the current El Nino climate pattern. Natural gas inventories are currently at the top of the historical five-year average in both the northeastern United States and Western Canada.

For the three months ended December 31, 2023, Headwater's natural gas sales decreased to $2.2 million from $10.7 million in the corresponding period of the prior year, due to a 70% decrease in realized commodity pricing and a 30% decrease in natural gas sales volumes. For the year ended December 31, 2023, Headwater's natural gas sales decreased to $11.9 million from $31.9 million in the prior year due to a 65% decrease in realized commodity pricing partially offset by a 7% increase in natural gas sales volumes. Realized natural gas pricing decreased due to lower benchmark pricing for both AGT and AECO 5A.

During the three months ended December 31, 2023, Headwater's natural gas sales volumes decreased to 8.0 mmcf/d from 11.5 mmcf/d in the corresponding period of the prior year as a result of lower natural gas production out of both Marten Hills and McCully. Headwater realized declining natural gas production in the core area of Marten Hills, while a portion of McCully production was deferred into 2024 due to mild weather in December. Headwater's natural gas sales volumes were fairly consistent year over year.

Consistent with prior years, the Company shut-in McCully natural gas production for the summer season effective May 1, 2023 and resumed operations December 1, 2023, to take advantage of the AGT market's premium winter pricing.

Financial Derivatives Gains

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Realized gains	6,203	4,240	46	14,066	37	na
Unrealized gains	1,868	5,516	(66)	4,863	2,184	123
Financial derivative gains	8,071	9,756	(17)	18,929	2,221	752
Per boe	4.36	6.81	(36)	2.88	0.47	513

Natural gas and crude oil commodity contracts

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

The realized financial derivative gains recognized during the three months ended December 31, 2023, of $6.2 million compared to $4.2 million in the corresponding period of the prior year, represent primarily both the Company's McCully natural gas contracts referenced to the AGT price and its Marten Hills' heavy oil contracts referenced to the WCS differential to WTI. The Company recognized $3.1 million of gains on its AGT contracts during the three months ended December 31, 2023, as the commodity contracts to fix the AGT price exceeded the settlement price in the period. The settlement price was lower than expected due to weather-driven market oversupply of natural gas. Headwater recognized $3.0 million of gains on its WCS differential contracts during the three months ended December 31, 2023, as the commodity contracts to fix the WCS to WTI spread were more favorable than the settlement differential. The settlement differential was wider than expected due to record supply out of Western Canada, pipeline apportionment and mild winter weather.

The realized financial derivative gains recognized during the year ended December 31, 2023, primarily relate to Headwater's first quarter McCully natural gas contracts referenced to the AGT price, in addition to the fourth quarter gains previously mentioned. A realized financial derivative gain was recorded during the year ended December 31, 2023, of $14.1 million compared to a realized gain of $37 thousand in the prior year.

The unrealized gains recorded are a result of the change in fair value of the Company's outstanding financial derivative commodity contracts over the periods. As at December 31, 2023, the fair value of Headwater's outstanding financial derivative commodity contracts was a net unrealized asset of $3.7 million as reflected in the audited financial statements. The fair value or mark to market value of these contracts is based upon the estimated amount that would have been receivable/payable as at December 31, 2023, had the contracts been monetized or terminated. Subsequent changes in the fair value of the contracts are recognized in each reporting period and could be materially different than what is recorded as at December 31, 2023. For the three months and year ended December 31, 2023, Headwater recognized unrealized gains of $1.9 million and $4.9 million, respectively, compared to unrealized gains of $5.5 million and $2.2 million in the corresponding periods of 2022.

As at December 31, 2023, Headwater had the following financial derivative commodity contracts outstanding:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Natural Gas	AGT	Fixed	Jan 2024	2,500 mmbtu	Cdn$18.95/mmbtu
Natural Gas	AGT	Fixed	Jan 2024 - Mar 2024	5,000 mmbtu	Cdn$16.98/mmbtu
Natural Gas	AECO 5A	Fixed	Apr 2024 - Oct 2024	1,000 GJ	Cdn$2.50/GJ
Natural Gas	WCS Basis	Differential	Apr 2024 - Jun 2024	1,000 bbl	US$15.95/bbl

Subsequent to December 31, 2023, the Company entered into additional financial derivative commodity contracts. Refer to the heading “Subsequent Events”.

Foreign exchange contracts

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 short-term foreign exchange contracts.

As at December 31, 2023, Headwater had the following financial derivative foreign exchange contract outstanding:

Type	Buy Currency	Sell Currency	Rate	Notional Amount	Settlement Date
Forward contract	CAD	USD	WMR noon rate, December 2023 average (1)	US$900,000	January 26, 2024

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

Subsequent to December 31, 2023, the Company entered into additional foreign exchange contracts. Refer to the heading “Subsequent Events”.

Royalty Expense

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Total royalty expense	23,916	19,352	24	85,686	85,162	1
Percentage of total sales, net of blending (1)	18.16%	18.80%	(3)	17.75%	19.80%	(10)
Per boe ($)	12.91	13.51	(4)	13.01	18.17	(28)

(1) Non-GAAP ratio. Refer to the advisory “Non-GAAP and Other Financial Measures”.

Royalty expense consists of crown oil and natural gas royalties payable to the Alberta and New Brunswick provincial governments and the gross overriding royalty payable to Topaz Energy Corp. Under the Alberta

Modernized Royalty Framework, the Company will pay a flat royalty of 5% on a well's production until the well's total revenue exceeds the drilling and completion cost allowance, then royalty rates increase on a sliding scale up to 40% depending on commodity reference pricing.

For the three months ended December 31, 2023, royalty expense increased to $23.9 million from $19.4 million in the corresponding period of 2022, representing an increase of 24% which is consistent with the increase in total sales (net of blending expense) over the period, of 28%. The royalty rate of 18.16% in the fourth quarter of 2023 is comparable with the royalty rate of 18.80% in the corresponding period of the prior year, as realized heavy oil commodity pricing was consistent over the same period.

Royalty expense of $85.7 million for the year ended December 31, 2023, is consistent with royalty expense of $85.2 million in the prior year. The increase in total sales (net of blending expense) year over year of 12% was offset by a decrease in the royalty rate of 10% over the same period. The decrease in royalty rate to 17.75% for the year ended December 31, 2023, from 19.80% in the prior year is relatively consistent with the decrease in realized heavy oil commodity pricing over the year.

Transportation Expense

	Three months ended December 31,		Percent	Year ended December 31,		Percent
	2023	2022	Change	2023	2022	Change
	(thousands of dollars)			*(thousands of dollars)*		
Transportation expense	9,493	6,025	58	35,196	20,067	75
Per boe ($)	5.12	4.21	22	5.35	4.28	25

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

For the three months and year ended December 31, 2023, transportation expense increased to $9.5 million and $35.2 million, respectively, from $6.0 million and $20.1 million in the corresponding periods of the prior year due to a significant increase in heavy oil sales volumes and higher trucking fees.

For the three months and year ended December 31, 2023, transportation expense per boe increased to $5.12 and $5.35, respectively, from $4.21 and $4.28 in the corresponding periods of the prior year. Downstream pipeline apportionment starting in early 2023 forced clean oil volumes, normally transported via pipeline, to be trucked out of the area resulting in higher transportation costs.

The Company expects transportation expense per boe to remain relatively flat into 2024. While Headwater expects additional pipeline capacity to reduce apportioned volumes going forward, an increase in clean oil volumes trucked out of the Company's newer areas is anticipated to offset the impact of lower apportionment.

Headwater has firm transportation service commitments in place to secure pipeline capacity to the point of sale. Refer to "Contractual Obligations and Commitments" for more information.

Production Expense

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			(thousands of dollars)		
Production expense	13,602	8,954	52	47,227	27,814	70
Per boe ($)	7.34	6.25	17	7.17	5.93	21

For the three months and year ended December 31, 2023, production expense increased to $13.6 million and $47.2 million, respectively, from $9.0 million and $27.8 million in the corresponding periods of the prior year due to a significant increase in production volumes.

For the three months and year ended December 31, 2023, production expense per boe increased to $7.34 and $7.17, respectively, from $6.25 and $5.93 in the corresponding periods of the prior year. Increased costs were due to substantial growth in Marten Hills West and the development of new areas in Greater Peavine which carry higher operating costs than the initial development area of Marten Hills. Production out of Marten Hills West grew significantly to 10,605 bbls/d of heavy oil in the fourth quarter of 2023 from 2,408 bbls/d of heavy oil in the same period of the prior year driving an increase in emulsion and water hauling costs. Higher carbon taxes also contributed to increased production expense for both the three months and year ended December 31, 2023.

Netbacks

Operating netback reflects the Company's margin on a per-barrel of oil equivalent basis. The following table provides a reconciliation of Headwater's operating netback and operating netback, including financial derivatives. Refer to the heading "Non-GAAP and Other Financial Measures" for more information.

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	($/boe)			($/boe)		
Sales	74.73	76.37	(2)	77.65	97.78	(21)
Royalties	(12.91)	(13.51)	(4)	(13.01)	(18.17)	(28)
Transportation and blending	(8.76)	(8.68)	1	(9.66)	(10.32)	(6)
Production expense	(7.34)	(6.25)	17	(7.17)	(5.93)	21
Operating netback [(1)]	45.72	47.93	(5)	47.81	63.36	(25)
Realized gains on financial derivatives	3.35	2.96	13	2.14	0.01	na
Operating netback, including financial derivatives [(1)]	49.07	50.89	(4)	49.95	63.37	(21)

(1) Non-GAAP ratio. Refer to the advisory "Non-GAAP and Other Financial Measures".

For the three months ended December 31, 2023, the Company recorded an operating netback, including financial derivatives of $49.07 per boe, which is consistent with the Company's operating netback, including financials derivatives of $50.89 per boe in the corresponding period of 2022. Higher production expense on a per boe basis was offset by higher realized gains on financial derivatives, while realized heavy oil pricing was comparable over the periods.

For the year ended December 31, 2023, the Company recorded a lower operating netback, including financial derivatives of $49.95 per boe compared to $63.37 per boe in the prior year, primarily as a result of lower realized commodity pricing and higher production expense per boe partially offset by lower royalties per boe and higher realized gains on financial derivatives driven by lower commodity pricing.

General and Administrative ("G&A") Expenses

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Gross G&A expenses	3,905	2,251	73	13,479	9,662	40
Capitalized G&A	(1,116)	(617)	81	(3,804)	(3,187)	19
Net G&A expenses	2,789	1,634	71	9,675	6,475	49
Per boe ($)	1.51	1.14	32	1.47	1.38	7

For the three months and year ended December 31, 2023, net G&A expenses increased to $2.8 million and $9.7 million, respectively, from $1.6 million and $6.5 million in the corresponding periods of 2022. Increased net G&A expenses on an absolute and per boe basis were mainly a result of increased employee related costs and professional fees due to the significant growth experienced by the Company over the periods.

Interest Income and Other Expense

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Interest income	1,633	1,833	(11)	6,519	3,844	70
Foreign exchange gains (losses)	166	205	(19)	(354)	(538)	(34)
Accretion on decommissioning liability	(361)	(225)	60	(1,183)	(709)	67
Interest on repayable contribution	(128)	(32)	300	(490)	(106)	362
Interest on lease liability	(16)	(17)	(6)	(49)	(74)	(34)
Total interest income and other expense	1,294	1,764	(27)	4,443	2,417	84
Per boe ($)	0.70	1.23	(43)	0.67	0.52	29

For both the three months and year ended December 31, 2023, Headwater generated significant interest income as a result of increasing interest rates in combination with carrying a large cash balance. This passive income was partially offset by realized and unrealized foreign exchange losses, accretion on the decommissioning liability and interest on repayable contribution and lease liability.

The increase in interest income to $6.5 million for the year ended December 31, 2023, from $3.8 million in the prior year, is a result of increasing interest rates. The current year opened with the prime rate at 6.45%, increasing to 7.20% mid-year where it held for the remainder of 2023, compared to entering 2022 with a prime rate of 2.45% and exiting the year at 6.45%. Interest income for the three months ended December 31, 2023, of $1.6 million is fairly consistent with interest income of $1.8 million in the corresponding period of the prior year.

The Company manages fluctuations in foreign exchange gains and losses by entering into foreign exchange contracts to fix the foreign exchange rate. Refer to "Financial Derivatives Gains" for more information.

Stock-based Compensation

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			(thousands of dollars)		
Stock options	249	635	(61)	1,280	2,883	(56)
Deferred share units	(161)	138	(217)	916	629	46
Share awards	1,283	670	91	4,748	2,102	126
Capitalized stock-based compensation	(469)	(369)	27	(1,704)	(1,529)	11
Stock-based compensation expense	902	1,074	(16)	5,240	4,085	28
Per boe ($)	0.49	0.75	(35)	0.80	0.87	(8)

During the three months ended December 31, 2023, stock-based compensation expense decreased to $0.9 million from $1.1 million in the corresponding period of 2022, as a result of lower expense associated with deferred share units ("DSUs") and restricted share units ("RSUs") due to the Company's share price decreasing to $6.25 at December 31, 2023, from $7.16 at September 30, 2023. The expense for stock options was also lower due to the majority of outstanding stock options being fully vested.

During the year ended December 31, 2023, stock-based compensation expense increased to $5.2 million from $4.1 million in the prior year, primarily due to grants of RSUs and performance share units ("PSUs" and collectively with the RSUs, the "Awards") under the Company's incentive awards plan (the "Award Plan") and grants of DSUs under the Company's DSU plan (the "DSU Plan").

Share Awards

The Award Plan provides for the grant of RSUs and PSUs to officers, employees and consultants of the Company. Under the Award 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 of the Company (the "Board"). The common shares underlying PSUs are adjusted based on a performance multiplier ranging from 0 to 2 times, which is determined based on certain corporate performance measures, as determined by the Board.

During the year ended December 31, 2023, the Board approved the cash settlement of RSUs. Previously, these Awards had been accounted for as equity-settled. As a result of this modification to the Company's outstanding RSUs from equity-settled to cash-settled, the fair value of the awards previously expensed was reclassified from contributed surplus to stock-based compensation payable. Subsequent to this modification, the grant date fair value is used to record the cost of the RSUs and any subsequent remeasurement of the liability is also recognized in the Statement of Income and Comprehensive Income.

It is the intention of the Company to equity settle any outstanding PSUs. The Award Plan allows a holder to receive common shares upon vesting. Headwater uses the fair value method for valuing the PSUs. The fair value of PSUs 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, with a portion being capitalized, 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 PSUs and settlement in common shares, the previously recognized value in contributed surplus will be recorded as an increase to capital stock.

As at December 31, 2023, there were 376,563 RSUs outstanding and 1,917,474 PSUs outstanding.

DSUs

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 Toronto Stock Exchange ("TSX"). It is the intention of the Company to settle the DSUs in cash. 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 Company's closing share price on December 31, 2023.

As at December 31, 2023, there were 263,555 DSUs outstanding.

Stock Options

The Company has an old and new stock option plan (the "Option Plans") 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 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 generally vest as to one third of the number granted on each of the first, second and third anniversaries of the date of grant over a three-year period and expire four to five years after the grant date. The Company did not grant any stock options in 2023 or 2022 and does not intend to grant any further options under the Option Plans.

As at December 31, 2023, there were 2,508,516 stock options outstanding under the Option Plans.

Depletion & Depreciation

	Three months ended December 31, 2023	Three months ended December 31, 2022	Percent Change	Year ended December 31, 2023	Year ended December 31, 2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Depletion	31,352	25,431	23	119,450	78,295	53
Depreciation	124	411	(70)	747	1,112	(33)
Depletion & depreciation	31,476	25,842	22	120,197	79,407	51
Depletion per boe ($)	16.93	17.76	(5)	18.14	16.70	9
Depreciation per boe ($)	0.07	0.29	(76)	0.11	0.24	(54)
Depletion & depreciation per boe ($)	17.00	18.05	(6)	18.25	16.94	8

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

Depletion and depreciation expense for the three months and year ended December 31, 2023, was $31.5 million and $120.2 million, respectively, compared to $25.8 million and $79.4 million in the corresponding periods of 2022. The increase in the absolute level of depletion expense for the three months and year ended December 31, 2023, is due to a significant increase in the Company's production volumes over the periods. Headwater's production volumes increased by 28% for the three months ended December 31, 2023, compared to the same period of the prior year and by 40% for the year ended December 31, 2023, compared to the prior year.

For the three months and year ended December 31, 2023, Headwater's depletion rate decreased to $16.93 per boe and increased to $18.14 per boe, respectively, from $17.76 per boe and $16.70 per boe in the corresponding periods of the prior year. The Company's depletion rate decreased in the fourth quarter due to a smaller capital program and reserve additions recorded in Headwater's 2023 year-end reserves report, resulting from successful drilling and waterflood results. Headwater's capital expenditures were $30.1 million in the fourth quarter of 2023, versus averaging $67.9 million for the first three quarters of the year. Headwater's depletion rate was higher for the year ended December 31, 2023, when compared to the prior year, primarily due to significant site preparation and infrastructure spend.

Impairment Assessment

As at December 31, 2023, there were no indicators of impairment identified for the Company's E&E (as defined herein) or property, plant and equipment ("PP&E") assets. As such, an impairment test was not performed.

Current and Deferred Income Taxes

	Three months ended December 31, 2023	2022	Percent Change	Year ended December 31, 2023	2022	Percent Change
	(thousands of dollars)			*(thousands of dollars)*		
Current income tax expense	7,668	1,075	613	36,990	14,393	157
Deferred income tax expense	5,740	10,749	(47)	9,912	35,173	(72)
Total income tax expense	13,408	11,824	13	46,902	49,566	(5)
Canadian statutory income tax rate	23.2%	23.3%	-	23.2%	23.3%	-
Current income tax per boe ($)	4.14	0.75	452	5.62	3.07	83
Deferred income tax per boe ($)	3.10	7.51	(59)	1.51	7.50	(80)
Total income tax per boe ($)	7.24	8.26	(12)	7.13	10.57	(33)

For the three months and year ended December 31, 2023, current income tax expense increased to $7.7 million and $37.0 million, respectively, from $1.1 million and $14.4 million in the corresponding periods of the prior year, due to higher taxable income as a result of lower available tax pool claims.

For the three months and year ended December 31, 2023, the Company recorded deferred income tax expense of $5.7 million and $9.9 million, respectively, compared to deferred income tax expense of $10.7 million and $35.2 million for the corresponding periods of the prior year. The Company's effective tax provision rate in 2023 is 23.2%.

At December 31, 2023, the Company had approximately $358.4 million of tax pools available to be applied against future taxable income. The federal tax pools are estimated as follows:

(thousands of dollars)	Estimated balance at December 31, 2023
Canadian oil and gas property expense	89,350
Canadian development expense	190,247
Undepreciated capital cost	77,726
Other	1,074
Total	358,397

Cash Flows Provided by Operating Activities and Adjusted Funds Flow from Operations

Refer to the heading "Non-GAAP and Other Financial Measures" for more information.

	Three months ended December 31,		Year ended, December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Cash flows provided by operating activities	90,690	66,448	303,316	283,925
Changes in non–cash working capital	(5,387)	6,455	(7,050)	10,195
Current income tax expense	(7,668)	(1,075)	(36,990)	(14,393)
Income taxes paid	4,348	-	28,986	-
Adjusted funds flow from operations (1)	81,983	71,828	288,262	279,727

	Three months ended December 31,		Year ended, December 31,	
	2023	2022	2023	2022
	($/boe)		*($/boe)*	
Cash flows provided by operating activities	48.96	46.39	46.07	60.57
Changes in non–cash working capital	(2.91)	4.51	(1.07)	2.18
Current income tax expense	(4.14)	(0.75)	(5.62)	(3.07)
Income taxes paid	2.35	-	4.40	-
Adjusted funds flow netback (2)	44.26	50.15	43.78	59.68

(1) Capital management measure. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
(2) Non-GAAP financial ratio. Refer to the advisory "Non-GAAP and Other Financial Measures".

For the three months ended December 31, 2023, cash flows provided by operating activities and adjusted funds flow from operations increased to $90.7 million and $82.0 million, respectively, from $66.4 million and $71.8 million in the corresponding period of the prior year, primarily attributable to a significant increase in total sales volumes and realized gains on financial derivatives, partly offset by higher cash costs and income taxes, while realized heavy oil pricing was flat over the period.

For the year ended December 31, 2023, cash flows provided by operating activities and adjusted funds flow from operations increased to $303.3 million and $288.3 million, respectively, from $283.9 million and $279.7 million in the prior year, primarily attributable to a significant increase in total sales volumes and realized gains on financial derivatives, partly offset by lower realized commodity pricing and higher cash costs and income taxes.

Capital Expenditures

	Three months ended December 31,		Percent	Year ended December 31,		Percent
	2023	2022	Change	2023	2022	Change
	(thousands of dollars)			*(thousands of dollars)*		
Land and geological and geophysical	998	1,435	(30)	17,265	32,505	(47)
Site preparation	6,131	12,916	(53)	27,821	38,070	(27)
Drilling and completions	19,493	39,394	(51)	162,266	134,189	21
Equipping and facilities	9,627	8,730	10	32,680	44,076	(26)
Corporate	25	39	(36)	38	83	(54)
	36,274	62,514	(42)	240,070	248,923	(4)
Government grant	(2,474)	(1,837)	35	(2,474)	(4,428)	(44)
Dispositions (1)	(3,750)	-	100	(3,750)	-	100
Capital expenditures (2)	30,050	60,677	(50)	233,846	244,495	(4)

(1) Relates to the sale of a gross overriding royalty. No gain or loss was recorded related to the sale.
(2) Non-GAAP financial measure. Refer to “Non-GAAP and Other Financial Measures” within this MD&A.

During the three months ended December 31, 2023, the Company invested a total of $30.1 million on capital expenditures including $19.5 million on drilling and completions, $9.6 million on equipping and facilities, $6.1 million on site preparation, including road construction, and $1.0 million on land and geological and geophysical. Additionally, Headwater sold a gross overriding royalty for gross proceeds of $3.8 million in the period.

During the year ended December 31, 2023, the Company invested a total of $233.8 million on capital expenditures including $162.3 million on drilling and completions, $32.7 million on equipping and facilities, $27.8 million on site preparation, including road construction, and $17.3 million on land and geological and geophysical costs.

The Company realized a $2.5 million reduction to capital expenditures during the three months and year ended December 31, 2023, in connection with its third and fourth claim submissions to the Government of Canada’s Emissions Reduction Funds (“ERF”) program. See “ESG Update” for more details.

Drilling Activity

The following table summarizes the Company’s drilling results:

	Three months ended December 31,				Year ended December 31,			
	2023		2022		2023		2022	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Crude oil (1)	14	14.0	30	30.0	90	90.0	97	97.0
Natural gas	-	-	-	-	-	-	-	-
Injection (2)	1	1.0	-	-	8	8.0	-	-
Source/stratigraphic test	-	-	2	2.0	3	3.0	9	9.0
Junked and abandoned (3)	-	-	-	-	-	-	1	1.0
Total	15	15.0	32	32.0	101	101.0	107	107.0
Success	100%	100%	100%	100%	100%	100%	100%	100%

(1) Of the 90 (90.0 net) crude oil wells drilled during the year ended December 31, 2023, 1 (1.0 net) was converted to injection and of the 97 (97.0 net) crude oil wells drilled during the year ended December 31, 2022, 31 (31.0 net) were converted to injection.
(2) Wells drilled straight to injection without ever producing crude oil.
(3) Well abandoned due to mechanical failure and did not reach the intended zone.

Decommissioning Liabilities

As at December 31, 2023, the decommissioning liabilities of the Company were $41.0 million. The Company recorded an increase of $8.7 million in the obligation from the decommissioning liability of $32.3 million as at December 31, 2022. This increase of $8.7 million is due to additions of $13.0 million and accretion expense of $1.2 million, partially offset by a downward change in estimate of $5.5 million. The change in estimate is a result of an increase to the time to abandonment and a decrease to the inflation rate to 1.6% at December 31, 2023 from 2.1 % at December 31, 2022, partially offset by a decrease to the risk-free rate to 3.0% at December 31, 2023 from 3.3% at December 31, 2022. The total undiscounted uninflated amount of estimated cash flows required to settle these obligations is $60.7 million (December 31, 2022 - $43.0 million).

2023 Guidance

A summary of the guidance that was provided by the Company in November 2023 compared to actual results from 2023, are as follows:

	2023 Guidance	2023 Actuals
2023 annual average production (boe/d) (1)	18,000	18,038
Adjusted funds flow from operations (2)	$285 million	$288 million
Capital expenditures (3)	$235 million	$234 million
Adjusted working capital (2)	$60 million	$64 million
Dividends (4)	$94 million	$94 million

(1) Refer to "Results of Operations – Production and Pricing" within this MD&A for a breakdown of 2023 annual average production by product type.
(2) Capital management measure. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
(3) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A
(4) Refer to "Dividend Policy" within this MD&A.

Actual results for the year ended December 31, 2023, are comparable to the Company's 2023 guidance.

2024 Guidance

The following table summarizes Headwater's current 2024 guidance to the guidance released on December 7, 2023. Headwater expects to fund capital expenditures through existing working capital and forecasted cash flows from operating activities.

	2024 Guidance December 7, 2023	2024 Guidance March 7, 2024
Average Daily Production		
Annual (boe/d)	20,000	20,000
Pricing		
Crude oil - WTI (US$/bbl)	70.00	75.30
Crude oil - WCS (Cdn$/bbl)	73.30	79.70
Exchange rate (Cdn$/US$)	0.74	0.74
Natural gas - AGT (US$/mmbtu)	9.10	5.05
Financial Summary ($millions)		
Estimated capital expenditures (1)	180	200
Estimated adjusted funds flow from operations (2)	275	298
Dividends (3)	95	95
Estimated exit adjusted working capital (2)	58	65

(1) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.
(2) Capital management measure. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
(3) Refer to "Dividend Policy" within this MD&A.
(4) For assumptions utilized in respect of the above guidance, see "Forward Looking Information" within this MD&A. Headwater expects to fund its 2024 capital expenditure budget through existing working capital and forecasted cash flows from operating activities.

Liquidity and Capital Resources

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, supplemented as necessary by equity and debt financings.

On November 3, 2022, Headwater announced its inaugural quarterly cash dividend of $0.10 per common share ($0.40 per common share annualized). The first dividend was paid on January 16, 2023, to shareholders of record at the close of business on December 30, 2022. During the year ended December 31, 2023, the Company declared $94.4 million (year ended December 31, 2022 - $23.4 million) related to its quarterly cash dividend. Included in current liabilities is the dividend payable of $23.7 million for the dividend declared on November 9, 2023, and paid out on January 15, 2024, to shareholders of record at the close of business on December 29, 2023.

As at December 31, 2023, the Company had cash of $146.1 million, adjusted working capital of $63.5 million and no outstanding bank debt. The Company expects to have adequate liquidity to fund its 2024 capital expenditure budget of $200 million, quarterly cash dividends and contractual obligations in the near term through existing working capital and forecasted adjusted funds flow from operations. Headwater anticipates that it will make use of debt or equity financing for any substantial expansion of its capital program or to finance any significant acquisitions.

To the extent that the Company's existing working capital is not sufficient to pay the cash portion of the purchase price for any future acquisition, Headwater anticipates that it will make use of additional equity or debt financings as available. Alternatively, the Company may issue equity as consideration to complete any future acquisition.

Credit Facility

The Company has a senior secured revolving syndicated credit facility with the National Bank of Canada and the Bank of Montreal ("the Lenders"). The credit facility is comprised of extendible revolving credit facilities consisting of a $20.0 million operating facility and an $80.0 million syndicated facility.

As at December 31, 2023, Headwater had not drawn on the credit facility. The Company does not intend to draw on its credit facility at current commodity pricing, however, Headwater may choose to draw on the facility to fund a substantial expansion of its capital program or a future acquisition.

The credit facility has a revolving period of 364 days, extendible annually at the request of the Company, subject to approval of the Lenders. The next scheduled renewal date of the facility is May 30, 2024. If the facility is not extended on the renewal date, the amount drawn will automatically convert to a term loan and all outstanding obligations will be repayable one year after the expiry of the revolving period. The borrowing base is subject to semi-annual redeterminations occurring by May 31st and by November 30th of each year. The credit facility is secured by a demand debenture in the amount of $250.0 million. Repayments of principal are not required until the maturity date, provided that the borrowings do not exceed the authorized borrowing base and the Company is in compliance with all covenants, representations and warranties.

The credit facility bears interest at a floating market rate with margins charged by the Lenders linked to the Company's senior debt to EBITDA ratio. EBITDA, for the purposes of calculating the senior debt to EBITDA ratio, is calculated as net income adjusted for non-cash items, interest expense and income taxes. Senior debt, for the purposes of calculating the senior debt to EBITDA ratio, is calculated as any debt of the Company excluding the financial derivative liability and repayable contribution.

The credit facility is not subject to any financial covenants. Additionally, distributions are permitted subject to compliance with a Board approved distributions policy.

Contractual Obligations and Commitments

The following table details the undiscounted contractual maturities of the Company's liabilities as at December 31, 2023:

	Within 1 year	1 to 5 years
	(thousands of dollars)	*(thousands of dollars)*
Accounts payable and accrued liabilities	73,715	-
Stock-based compensation payable	2,431	498
Financial derivative liability	79	-
Current income tax liability	22,397	-
Dividends payable	23,658	-
Lease liability	100	1,042
Repayable contribution	-	14,168
Total	122,380	15,708

As at December 31, 2023, the Company is committed to future payments under the following agreements:

(thousands of dollars)	Total	2024	2025	2026	2027	2028	Thereafter
	$	$	$	$	$	$	$
Transportation and operating (1)	149,582	14,851	19,205	20,995	22,170	22,522	49,839
Capital (2)	3,000	3,000	-	-	-	-	-
Lease (3)	2,582	444	452	460	468	476	282
Government grant (4)	14,168	-	1,417	4,675	8,076	-	-

(1) At December 31, 2023, Headwater has the following commitments:
   a. 7- year take-or-pay transportation agreement with a minimum volume commitment of 10,000 boe/d.
   b. 7- year financial commitment at $1.9 million per year adjusted for inflation.
   c. 7- year take-or-pay transportation agreement with a current minimum volume commitment of 9,750 boe/d, increasing to 12,500 boe/d in 2026
   d. 5-year take-or-pay transportation agreement with a current minimum volume of 191 m^3/d, increasing to 318 m^3/d in 2025 and increasing to 398 m^3/d for the remaining 3 years.
   e. During the year ended December 31, 2023, the Company entered into an agreement to construct a natural gas gathering system with an estimated capital cost of approximately $22.5 million. Once commissioned, which is expected to occur late 2024, the Company is entitled to be reimbursed the capital costs, in respect thereof, and will be subject to a long-term fixed take-or-pay contract. The estimated capital costs and timing of the project are preliminary and subject to change.

(2) Relates to a capital commitment entered into pursuant to the sale of a gross overriding royalty.
(3) Relates to variable operating costs, which are a non-lease component of the Company's head office lease.
(4) Relates to scheduled undiscounted re-payments of federal government funding under the terms of the repayable contribution agreement with Natural Resources Canada.
(5) Excludes leases accounted for under IFRS 16.

Common Share Information

Share Capital

(thousands)	Three months ended December 31,		Year ended December 31,	
	2023	2022	2023	2022
Weighted average outstanding common shares [(1)]				
-Basic	236,408	231,766	235,583	227,299
-Diluted	238,872	235,305	237,705	230,755
Outstanding securities at December 31, 2023				
-Common shares				236,580
-Stock options – weighted average strike price of $3.88				2,508
-Restricted share units				377
-Performance share units				1,917
-Deferred share units				264

(1) The Company uses the treasury stock method to determine the dilutive effect of stock options, RSUs and PSUs. Under this method, only “in-the-money” dilutive instruments impact the calculation of diluted income per common share. This method also assumes that the proceeds received from the exercise of all “in-the-money” dilutive instruments are used to repurchase shares at the average market price.

Stock Options

During the year ended December 31, 2023, 3.0 million stock options were exercised for 2.1 million common shares on a cashless basis, and 0.6 million stock options were exercised for 0.6 million common shares for total proceeds of $1.0 million. Contributed surplus related to the options exercised of $2.8 million was transferred to capital stock.

During the year ended December 31, 2022, 2.8 million stock options were exercised for 2.1 million common shares on a cashless basis, and 0.6 million stock options were exercised for 0.6 million common shares for total proceeds of $0.9 million. Contributed surplus related to the options exercised of $2.4 million was transferred to capital stock.

Total Market Capitalization

The Company’s market capitalization at December 31, 2023 was approximately $1.5 billion.

(thousands)	December 31, 2023
Common shares outstanding	236,580
Share price [(1)]	$6.25
Total market capitalization	$1,478,625

(1) Represents the last price traded on the TSX on December 31, 2023.

As at March 7, 2024, the Company had 236,673,373 common shares outstanding.

(thousands)	March 7, 2024
Outstanding securities at March 7, 2024	
-Common shares	236,673
-Stock options – weighted average strike price of $4.00	2,400
-Restricted share units	376
-Performance share units	1,917
-Deferred share units	355

ESG Update

Headwater remains committed to strong ESG performance. Recent achievements related to the Company's ESG strategy include:

- On October 25, 2023, Headwater entered into an agreement with a third party to construct a gas gathering system in Marten Hills West, which is expected to allow the Company to conserve a meaningful amount of its natural gas production in the area.

- Headwater formed an Environment, Safety and Sustainability Committee, which is comprised of independent members of the Board, to develop the Company's approach to matters concerning the environment, health, safety and sustainability.

- Achieved its board diversification commitment to increase women representation on the Board to 30% by the 2023 annual shareholder meeting. Devery Corbin was appointed to the Board in May 2023 at Headwater's annual shareholder meeting.

- Headwater has received total funding of $17.7 million from Natural Resources Canada ("NRCan") in connection with four claim submissions to the ERF program. NRCan has provided 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. The repayable portion of the funds received are to be repaid as follows: 10% on June 30, 2025, 33% on June 30, 2026, and 57% on June 30, 2027.

- Headwater released its inaugural ESG report on November 3, 2022, highlighting key factors of the Company's ESG program including emissions management, Indigenous and community engagement and sustainability stewardship. For more information, see the Company's ESG report and updated 2022 Performance Tables on the Company's website at www.headwaterexp.com.

In addition to the Environment, Safety and Sustainability Committee, the Board has also established the Audit Committee, Reserves Committee and Corporate Governance and Compensation Committee which are all comprised of independent members of the Board. The Audit Committee and the Reserves Committee ensure the integrity of the financial and reserves reporting of the Company, while the Corporate Governance and Compensation Committee is charged with independent oversight of the director nomination process, executive compensation decisions and other corporate governance matters. For additional information relating to the governance policies and structure of the Company see the Company's management information circular dated March 27, 2023 for the annual meeting of the shareholders held on May 11, 2023, which is available on SEDAR+ at www.sedarplus.ca and the information under the heading Corporate Responsibility on the Company's website at www.headwaterexp.com.

Related Party Transactions

Key management personnel of the Company include its directors and senior management. In 2023, the Company recorded $4.9 million (2022 – $3.3 million) relating to compensation of key management personnel. In 2023, stock-based compensation expense, including amounts capitalized to PP&E, relating to compensation of key management personnel was $5.0 million (2022 – $3.9 million).

Selected Annual Financial Information

The following table summarizes key annual financial and operating information over the most recently completed financial years.

	2023	2022	2021
(thousands of dollars except share data and production volumes)			
Average production volumes (boe/d) (1)	18,038	12,841	7,393
Average sales volumes (boe/d)	18,038	12,843	7,390
Total sales, net of blending (2)	482,823	430,047	179,517
Net income	156,072	162,109	45,828
Net income per share			
-basic	0.66	0.71	0.23
-diluted	0.66	0.70	0.21
Cash flows provided by operating activities	303,316	283,925	111,656
Adjusted funds flow from operations (3)	288,262	279,727	117,916
Adjusted funds flow from operations per share (4)			
-basic	1.22	1.23	0.59
-diluted	1.21	1.21	0.55
Working capital	78,610	109,433	89,775
Adjusted working capital (3)	63,526	104,918	92,929
Dividends declared	94,421	23,392	-
Per share	0.40	0.10	-
Capital expenditures (2)	233,846	244,495	140,389
Total assets	836,335	734,742	488,807

(1) Refer to "Results of Operations – Production and Pricing" within this MD&A for a breakdown of 2023 and 2022 annual average production by product type. 2021 average production consisted of 6,665 bbls/d of heavy oil, 4.4 mmcf/d of natural gas and 2 bbls/d of natural gas liquids.
(2) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.
(3) Capital management measure. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
(4) Non-GAAP ratio that does not have any standardized meaning under IFRS and therefore may not be comparable with the calculation of similar measures of other entities. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.

Headwater has grown annual average production volumes significantly from 7,393 boe/d in 2021 to 12,841 boe/d in 2022 to 18,038 boe/d in 2023, resulting in record annual cash flows from operating activities of $303.3 million and record annual adjusted funds flow from operations of $288.3 million. Coinciding with this growth, the Company declared its inaugural quarterly dividend of $0.10 per common share in the fourth quarter of 2022. In 2023, a total of $0.40 per common share or $94.4 million in dividends were declared to shareholders.

Summary of Quarterly Information

	Q4/23	Q3/23	Q2/23	Q1/23	Q4/22	Q3/22	Q2/22	Q1/22
Financial *(thousands of dollars except share data and production volumes)*								
Total sales	138,426	149,632	118,967	104,209	109,377	99,587	130,153	119,262
Total sales, net of blending (1) (2)	131,690	144,003	112,560	94,570	102,974	94,949	122,102	110,022
Adjusted funds flow from operations (3)	81,983	80,887	66,235	59,157	71,828	58,441	79,435	70,023
Per share - basic (4)	0.35	0.34	0.28	0.25	0.31	0.25	0.35	0.32
- diluted (4)	0.34	0.34	0.28	0.25	0.31	0.25	0.34	0.30
Cash flows provided by operating activities	90,690	85,568	66,857	60,201	66,448	72,060	84,728	60,689
Net income	45,469	49,677	30,947	29,979	39,789	31,545	48,412	42,363
Per share - basic	0.19	0.21	0.13	0.13	0.17	0.14	0.21	0.19
- diluted	0.19	0.21	0.13	0.13	0.17	0.13	0.21	0.18
Capital expenditures (2)	30,050	70,208	64,094	69,494	60,677	71,001	30,860	81,957
Depletion and depreciation	31,476	30,723	29,341	28,657	25,842	17,284	17,243	19,038
Adjusted working capital (3)	63,526	35,921	48,968	70,467	104,918	117,967	130,206	80,072
Working capital	78,610	43,496	54,765	77,415	109,433	113,381	127,101	77,122
Shareholders' equity	610,498	587,380	559,779	551,160	543,335	525,006	492,145	441,148
Dividends declared	23,658	23,638	23,586	23,539	23,392	-	-	-
Per share	0.10	0.10	0.10	0.10	0.10	-	-	-
Weighted average shares *thousands)*								
Basic	236,408	236,191	235,631	234,069	231,766	229,909	226,168	221,209
Diluted (5)	238,872	239,167	237,913	236,279	235,305	236,658	233,479	234,265
Shares outstanding, end of period *(thousands)*								
Basic	236,580	236,384	235,864	235,386	233,920	229,911	229,908	223,727
Diluted (6)	241,138	241,175	241,240	241,368	241,029	241,593	241,585	241,688
Operating *(6:1 boe conversion)*								
Average daily production								
Heavy oil *(bbls/d)*	18,514	16,902	15,624	14,777	13,536	10,842	10,637	10,602
Natural gas *(mmcf/d)*	8.0	6.1	8.5	12.8	11.5	4.3	6.4	10.8
Natural gas liquids *(bbls/d)*	93	103	107	91	99	55	66	7
Barrels of oil equivalent *(boe/d)* (7)	19,939	18,027	17,152	17,004	15,546	11,612	11,772	12,414
Average daily sales (8)	20,134	17,862	17,154	16,968	15,568	11,680	11,705	12,398
Average selling prices								
Heavy oil *($/bbl)*	74.69	92.05	77.14	65.41	73.10	92.35	121.49	98.80
Natural gas *($/mcf)*	3.00	2.36	2.51	5.58	10.15	4.23	7.28	15.65
Natural gas liquids *($/bbl)*	73.53	86.65	75.01	66.53	73.02	95.54	113.61	108.57
Barrels of oil equivalent *($/boe)*	70.94	87.56	71.98	61.40	71.60	88.27	114.34	98.09
Netbacks ($/boe)								
Operating								
Sales, net of blending	71.09	87.63	72.11	61.93	71.90	88.36	114.63	98.60
Realized gain (loss) on financial derivatives	3.35	0.18	0.21	4.74	2.96	-	(0.24)	(3.54)
Royalties	(12.91)	(16.26)	(12.63)	(10.04)	(13.51)	(21.93)	(23.85)	(15.09)
Transportation	(5.12)	(5.32)	(5.48)	(5.50)	(4.21)	(3.94)	(4.07)	(4.90)
Production	(7.34)	(7.43)	(7.33)	(6.53)	(6.25)	(5.95)	(5.66)	(5.77)
Operating netback, including financial derivatives *($/boe)* (4) (9)	49.07	58.80	46.88	44.60	50.89	56.54	80.81	69.30
General and administrative	(1.51)	(1.52)	(1.49)	(1.35)	(1.14)	(1.46)	(1.52)	(1.48)
Interest income and other expense (10)	0.84	0.85	0.96	1.11	1.15	1.18	0.44	0.14
Current income taxes	(4.14)	(8.91)	(3.91)	(5.61)	(0.75)	(1.87)	(5.16)	(5.21)
Adjusted funds flow netback *($/boe)* (4) (9)	44.26	49.22	42.44	38.75	50.15	54.39	74.57	62.75

(1) Heavy oil sales are netted with blending expense to compare the realized price to benchmark. In the audited annual financial statements, blending is recorded in blending and transportation expense.
(2) Non-GAAP financial measure. Refer to "Non-GAAP and Other Financial Measures" within this MD&A.
(3) Capital management measure. Refer to "Management of capital" in note 16 of the audited annual financial statements and to "Non-GAAP and Other Financial Measures" within this MD&A.
(4) Non-GAAP ratio. Refer to the advisory "Non-GAAP and Other Financial Measures".
(5) Diluted weighted average shares outstanding includes the impact of any stock options, RSUs and PSUs that would be outstanding as dilutive instruments using the treasury stock method.
(6) Includes in-the-money dilutive instruments as at December 31, 2023 which include 2.5 million stock options with a weighted average exercise price of $3.88 and 2.0 million PSUs. The number of outstanding PSUs has been adjusted for dividends. RSUs have been excluded as the Company intends to cash settle these awards.
(7) See barrels of oil equivalent under "Oil and Gas Measures".
(8) Includes sales of unblended heavy crude oil. The Company's heavy oil sales volumes and production volumes differ due to changes in inventory.
(9) Netbacks are calculated using average sales volumes.
(10) Excludes unrealized foreign exchange gains/losses, accretion on decommissioning liabilities, interest on repayable contribution and interest on lease liability.

Headwater has experienced significant quarterly growth over the past two years as a result of its significant capital expenditure programs. The Company has grown production from 12,414 boe/d in the first quarter of 2022 to 19,939 boe/d in the fourth quarter of 2023, while maintaining a significant positive working capital balance and distributing a quarterly dividend since announcing its dividend policy in the fourth quarter of 2022. This production growth is attributed to successful drilling results in the Company's Marten Hills core and west areas, as well as newer exploration prospects within Greater Peavine and West Nipisi. While commodity pricing retreated in 2023 due to market oversupply concerns, Headwater realized record adjusted funds flow from operations of $82.0 million as a result of record production of 19,939 boe/d in the fourth quarter of 2023.

Off-Balance Sheet Arrangements

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

Subsequent Events

a) Dividend

Subsequent to December 31, 2023, the Company declared a cash dividend of $0.10 per common share. The dividend will be payable on April 15, 2024, to shareholders of record at the close of business on March 29, 2024. The dividend is designated as an eligible dividend for Canadian income tax purposes.

b) Financial derivative commodity contracts and foreign exchange contracts:

Subsequent to December 31, 2023, Headwater entered into the following financial derivative contracts:

Commodity	Index	Type	Term	Daily Volume	Contract Price
Crude Oil	WCS Basis	Differential	Apr 2024 - Jun 2024	4,000 bbl	US$14.99/bbl
Crude Oil	WCS Basis	Differential	Jul 2024 - Sep 2024	3,000 bbl	US$13.25/bbl
Natural Gas	AGT	Fixed	Feb 6-29 2024	2,500 mmbtu	Cdn$9.11/mmbtu
Natural Gas	AGT	Fixed	April 2024	2,500 mmbtu	Cdn$2.33/mmbtu
Natural Gas	AGT	Fixed	Dec 2024 - Mar 2025	2,500 mmbtu	Cdn$10.65/mmbtu
Natural Gas	AECO 5A	Fixed	Apr 2024 - Oct 2024	1,000 GJ	Cdn$1.74/GJ
Natural Gas	AECO 5A	Fixed	Apr 2025 - Oct 2025	2,000 GJ	Cdn$2.78/GJ

Subsequent to December 31, 2023, 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 2024 average	US$2,000,000	February 27, 2024
Forward contract	CAD	USD	WMR noon rate, February 2024 average	US$875,000	March 26, 2024

Non-GAAP and Other Financial Measures

Throughout this MD&A, the Company uses various non-GAAP and other financial measures to analyze operating performance and financial position. These non-GAAP and other financial measures do not have standardized meanings prescribed under IFRS and therefore may not be comparable to similar measures presented by other entities.

Non-GAAP Financial Measures

Free cash flow

Management utilizes free cash flow to assess the amount of funds available for future capital allocation decisions. It is calculated as adjusted funds flow from operations net of capital expenditures before dividends.

	Three months ended December 31,		Year ended December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Adjusted funds flow from operations	81,983	71,828	288,262	279,727
Capital expenditures	(30,050)	(60,677)	(233,846)	(244,495)
Free cash flow	51,933	11,151	54,416	35,232

Heavy oil sales, net of blending

Management utilizes heavy oil sales, net of blending expense to compare realized pricing to WCS benchmark pricing. It is calculated by deducting the Company's blending expense from heavy oil sales. In the annual financial statements blending expense is recorded within blending and transportation expense.

	Three months ended December 31,		Year ended December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Heavy oil sales	135,302	97,584	495,177	423,211
Blending expense	(6,736)	(6,403)	(28,411)	(28,332)
Heavy oil sales, net of blending expense	128,566	91,181	466,766	394,879

Total sales, net of blending

Management utilizes total sales, net of blending expense to compare realized pricing to benchmark pricing. It is calculated by deducting the Company's blending expense from total sales. In the audited annual financial statements blending expense is recorded within blending and transportation expense.

	Three months ended December 31,		Year ended December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Total sales	138,426	109,377	511,234	458,379
Blending expense	(6,736)	(6,403)	(28,411)	(28,332)
Total sales, net of blending expense	131,690	102,974	482,823	430,047

Capital expenditures

Management utilizes capital expenditures to measure total cash capital expenditures incurred in the period. Capital expenditures represents capital expenditures – E&E and capital expenditures – PP&E in the statement of cash flows in the Company’s audited annual financial statements netted by the government grant.

	Three months ended December 31,		Year ended December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Cash flows used in investing activities	54,716	61,957	243,714	232,056
Proceeds from government grant	1,200	780	1,200	1,988
Restricted cash	-	5,000	-	-
Change in non-cash working capital	(23,392)	(5,223)	(8,594)	14,879
Government grant	(2,474)	(1,837)	(2,474)	(4,428)
Capital expenditures	30,050	60,677	233,846	244,495

Capital Management Measures

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 and dividend policy. Management believes that by excluding the impact of changes in non-cash working capital and adjusting for current income taxes in the period, 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.

	Three months ended December 31,		Year ended, December 31,	
	2023	2022	2023	2022
	(thousands of dollars)		*(thousands of dollars)*	
Cash flows provided by operating activities	90,690	66,448	303,316	283,925
Changes in non–cash working capital	(5,387)	6,455	(7,050)	10,195
Current income tax expense	(7,668)	(1,075)	(36,990)	(14,393)
Current income taxes paid	4,348	-	28,986	-
Adjusted funds flow from operations	81,983	71,828	288,262	279,727

Adjusted Working Capital

Adjusted working capital is a capital management measure which management uses to assess the Company's liquidity. Financial derivative receivable/liability have been excluded as these contracts are subject to a high degree of volatility prior to settlement and relate to future production periods. Financial derivative receivable/liability are included in adjusted funds flow from operations when the contracts are ultimately realized. Management has included the effects of the contribution receivable and repayable contribution to provide a better indication of Headwater's net financing obligations.

	Year ended December 31, 2023	2022
	(thousands of dollars)	
Working capital	78,610	109,433
Contribution receivable (long-term)	-	1,104
Repayable contribution	(11,405)	(6,720)
Financial derivative receivable	(3,758)	(419)
Financial derivative liability	79	1,520
Adjusted working capital	63,526	104,918

Non-GAAP Ratios

Adjusted funds flow netback, operating netback and operating netback, including financial derivatives

Adjusted funds flow netback, operating netback and operating netback, including financial derivatives are non-GAAP ratios and are used by management to better analyze the Company's performance against prior periods on a more comparable basis.

Adjusted funds flow netback is defined as adjusted funds flow from operations divided by sales volumes in the period.

Operating netback is defined as sales less royalties, transportation and blending costs and production expense divided by sales volumes in the period. Sales volumes exclude the impact of purchased condensate. Operating netback, including financial derivatives is defined as operating netback plus realized gains on financial derivatives.

Adjusted funds flow per share

Adjusted funds flow per share is a non-GAAP ratio used by management to better analyze the Company's performance against prior periods on a more comparable basis. Adjusted funds flow per share is calculated as adjusted funds flow from operations divided by weighted average shares outstanding during the applicable period on a basic or diluted basis.

Royalty rate or percentage of total sales, net of blending

Corporate royalty rate or percentage of total sales, net of blending are non-GAAP ratios used by management and are calculated as total royalties divided by total sales, net of blending expense, expressed as a percentage.

Supplementary Financial Measures

Per boe numbers

This MD&A represents various results on a per boe basis including net income, average realized sales price, financial derivatives gains (losses) per boe, royalty expense per boe, transportation and blending expense per boe, production expense per boe, general and administrative expenses per boe, interest income and other expense per boe, stock-based compensation expense per boe, depletion and depreciation per boe, current income tax per boe, deferred income tax per boe and total income tax per boe. These figures are calculated using sales volumes.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

The Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") of the Company have designed, or caused to be designed under their supervision, disclosure controls and procedures as defined in National Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109") of the Canadian Securities Administrators, to provide reasonable assurance that: (i) information required to be disclosed by an issuer in its annual filings, interim filings or other reports filed or submitted under securities legislation is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure; and (ii) information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation.

The CEO and the CFO have evaluated the effectiveness of Headwater's disclosure controls and procedures as at December 31, 2023 and have concluded that such disclosure controls and procedures were effective as at such date.

The CEO and the CFO of Headwater have designed, or caused to be designed under their supervision, internal controls over financial reporting ("ICFR") as defined in NI 52-109. The control framework Headwater's officers used to design the Company's ICFR is the COSO Framework published by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). The CEO and CFO have concluded that the Company's ICFR were effective as of December 31, 2023. There have been no changes in the ICFR during the period from October 1, 2023, to December 31, 2023, that have materially affected, or are reasonably likely to materially affect the Company's ICFR.

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

Critical Accounting Estimates

Use of estimates and judgments

The preparation of the Company's financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported 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. Estimates are more difficult to determine, and the range of potential outcomes can be wider, in periods of higher volatility and uncertainty. The impacts of various events such as the Russian invasion of Ukraine and the war between Israel and Hamas and its impact on energy markets and general market conditions, increased interest and inflation rates and supply chain uncertainties have created a higher level of volatility and uncertainty. Management has, to the extent reasonable, incorporated known facts and circumstances into the estimates made however, actual results could differ from those estimates and those differences could be material. The Company has identified the following areas requiring significant judgments, assumptions or estimates.

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, 2023. 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 standards such as these, when they are approved by Canadian regulators, 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, 2023 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 25 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 2023 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 consistent with the Emissions Management and Climate Resilience Act (Alberta).

The evolving energy transition and general public sentiment to the oil and gas industry may result in reduced access to capital markets. Management will continue to adjust the capital structure as necessary in response to changing industry conditions.

The Company's financial results for 2023 were not materially impacted from a climate event. In 2023, the Company did not incur material weather related damages to its PP&E. During 2023, management is not aware of a material disruption in its supply chain or to 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 2023 with respect to climate related matters.

Critical Judgments in Applying Accounting Policies

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.

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.

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 PP&E and E&E 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:

- 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.

- 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.

- 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.

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

Decommissioning liabilities

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

Valuation of financial instruments

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

Valuation of performance share units ("PSUs")

The estimate of stock-based compensation in respect of the Company's PSUs is dependent on the performance multiplier estimated by management.

New accounting policies

On January 1, 2023, the Company adopted amendments to IAS 12 "Income Taxes" re: deferred tax related to assets and liabilities arising from a single transaction. These amendments require entities to recognize deferred tax on transactions that, on initial recognition, give rise to equal amounts of taxable and deductible temporary differences.

These amendments to IAS 12 did not have a material impact on the Company's financial statements.

Future accounting pronouncements

The IASB issued amendments 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, 2024. 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.

These new amendments to IAS 1 are not expected to have a material impact on the Company's financial statements.

Changing regulation

On June 26, 2023, the International Sustainability Standards Board ("ISSB") issued IFRS S1 - General Requirements for Disclosure of Sustainability-Related Financial Information ("IFRS S1"), and IFRS S2 – Climate Related Disclosures ("IFRS S2"). IFRS S1 and IFRS S2 are effective for annual reporting periods beginning on or after January 1, 2024. The sustainability standards as issued by the ISSB provide for transition relief in IFRS S1 that allow a reporting entity to report only on climate-related risks and opportunities, as set out in IFRS S2, in the first year of reporting under the sustainability standards.

The Canadian Securities Administrators ("CSA") are responsible for determining the reporting requirements for public companies in Canada and are responsible for decisions related to the adoption of the sustainability disclosure standards, including the effective annual reporting dates. The CSA issued proposed National Instrument NI 51-107 – Disclosure of Climate-Related Matters in October 2021. The

CSA has indicated it will consider the ISSB sustainability standards and developments in the United States in its decisions related to developing climate-related disclosure requirements for reporting issuers in Canada. The CSA will involve the Canadian Sustainability Standards Board ("CSSB") for their combined review of the ISSB issued sustainability standards for their suitability for adoption in Canada. Until such time as the CSA and CSSB make decisions on sustainability standard adoption here in Canada, there is no requirement for public companies in Canada to adopt the sustainability standards. The Company is committed to transparent and comprehensive reporting of its sustainability performance and is actively evaluating the potential effects of the ISSB issued sustainability standards; however, at this time, the Company is not able to determine the impact on future financial statements, nor the potential costs to comply with these sustainability standards.

Business Conditions and Risks

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

- Volatility in the market conditions for the oil and natural gas industry may affect the value of the Company's reserves and restrict its cash flow and ability to access capital to fund the development of it properties;
- Various factors may adversely impact the marketability of oil and natural gas, affecting net production revenue, production volumes and development and exploration activities;
- The anticipated benefits of acquisitions may not be achieved and the Company may dispose of non-core assets for less than their carrying value on the financial statements as a result of weak market conditions;
- The impact of the Russian Ukrainian conflict and the Israel-Palestine war on commodity prices and the world economy could affect the Company's results, business, financial conditions or liquidity;
- Natural disasters, terrorist acts, civil unrest, war, pandemics and other disruptions and dislocations may affect the Company's results, business, financial conditions or liquidity;
- The Company's business may be adversely affected by political and social events and decisions made in Canada, the United States, Europe and elsewhere;
- Lack of capacity and/or regulatory constraints on gathering and processing facilities and pipeline systems may have a negative impact on the Company's ability to produce and sell its oil and natural gas;
- The Company competes with other oil and natural gas companies, some of which have greater financial and operational resources;
- The Company's ability to successfully implement new technologies into its operations in a timely and efficient manner will affect its ability to compete;
- Changes to the demand for oil and natural gas products and the rise of petroleum alternatives may negatively affect the Company's financial condition, results of operations and cash flow;
- Modification to current, or implementation of additional, regulations (including environmental regimes) or royalty regimes may reduce the demand for oil and natural gas, impact the Company's cash flows and/or increase the Company's costs and/or delay planned operations;
- Taxes on carbon emissions affect the demand for oil and natural gas, the Company's operating expenses and may impair the Company's ability to compete;
- Liability management programs enacted by regulators in the western provinces may prevent or interfere with the Company's ability to acquire properties or require a substantial cash deposit with the regulator;

- The Company may require additional financing, from time to time, to fund the acquisition, exploration and development of properties and its ability to obtain such financing in a timely fashion and on acceptable terms may be negatively impacted by the current economic and global market volatility;
- Changing investor sentiment towards the oil and natural gas industry may impact the Company's access to, and cost of, capital;
- Oil and natural gas operations are subject to seasonal weather conditions and, if applicable to the Company's operations in the future, the Company may experience significant operational delays as a result;
- Regulatory water use restrictions and/or limited access to water or other fluids may impact the Company's future production volumes from any future waterflood of the Company;
- Credit risk related to non-payment for sales contracts or other counterparties;
- Foreign exchange risk as commodity sales are based on U.S. dollar denominated benchmarks; and
- The risk of significant interruption or failure of the Company's information technology systems and related data and control systems or a significant breach that could adversely affect the Company's operations.

Additional risks and information on risk factors are included in the Annual Informational Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR+ at www.sedarplus.ca.

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

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

Oil and Gas

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

References to heavy oil, natural gas, and natural gas liquids in the MD&A refer to heavy crude oil, conventional natural gas and natural gas liquids, respectively, product types as defined in NI 51-101.

Dividend Policy

The amount of future cash dividends paid by the Company, if any, will be subject to the discretion of the Board and may vary depending on a variety of factors and conditions existing from time to time, including, among other things, adjusted funds flow from operations, fluctuations in commodity prices, production levels, capital expenditure requirements, acquisitions, debt service requirements and debt levels, operating costs, royalty burdens, foreign exchange rates and the satisfaction of the liquidity and solvency tests imposed by applicable corporate law for the declaration and payment of dividends. Depending on these and various other factors, many of which will be beyond the control of the Company, the Board will adjust the Company's dividend policy from time to time and, as a result, future cash dividends could be reduced or suspended entirely.

Reserves Information

Reserves information as at December 31, 2023 as presented herein is based on a report (the "2023 Reserves Report") prepared by McDaniel & Associates Consultants Ltd. ("McDaniels") assessing the Company's reserves effective December 31, 2023 which were prepared in accordance with standards of the Canadian Oil and Gas Evaluation Handbook and NI 51-101 and is based on the average forecast prices as at December 31, 2023 of three independent reserves evaluation firms. Additional information regarding reserves data and other oil and gas information is included in Headwater's Annual Information Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at and under the Company's profile on SEDAR+ at www.sedarplus.ca .

Forward Looking Information

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

- business plans and strategies (including its production optimization and hedging strategies);
- the expectation Marten Hills West natural gas tie-in infrastructure will cost $22.5 million, commission in late 2024 and conserve a meaningful amount of Headwater's natural gas production in the area significantly reducing future carbon tax obligations;
- that weaker WCS pricing is expected into 2024 until the commissioning of the Trans Mountain pipeline expansion;
- the expectation that transportation expense per boe will remain relatively flat into 2024;
- the expectation that additional pipeline capacity will reduce apportioned volumes going forward and the expectation the impact of lower apportionment will be offset by an increase in clean oil volumes trucked out of the Company's newer areas;
- the Company's intent to settle PSUs in equity;
- the Company's intent to settle DSUs and RSUs in cash;
- the Company's intent to not grant any further options under the Option Plans;
- the expectation that Headwater could make use of additional equity or debt financings to fund any substantial increase of its capital expenditure program or for future acquisitions;
- the expectation that the Company has adequate liquidity to fund its 2024 capital expenditure budgets, future dividend payments and contractual obligations in the near term through existing working capital and forecasted cash flows from operations;
- the expectation that Headwater does not intend to draw on its credit facility at current commodity pricing;

- 2024 crude oil and natural gas pricing assumptions;
- 2024 Canadian – U.S. dollar exchange rates;
- 2024 budget and guidance related to annual production, capital expenditures, dividends, adjusted funds flow from operations and adjusted working capital;
- the Company's objectives with respect to managing capital;
- the Company's future contractual obligations and commitments;
- the expectation that the energy transition and general public sentiment to oil and gas may reduce access to capital markets and the expectation that the Company will adjust its capital structure as necessary in response to changing industry conditions;
- Headwater's commitment to strong ESG performance;
- the Company's dividend policy;
- the expectation that the amendment to IAS 1 will not have a material impact on the Company's financial statements;
- the Company's commitment to transparent and comprehensive reporting of its sustainability performance and active evaluation of the potential effects of the ISSB issued sustainability standards;
- the estimated amount to settle the Company's decommissioning liabilities; and
- the expectation that the majority of the Company’s proved and probable reserves per the 2023 reserve report should be realized prior to the elimination of carbon-based energy.

Statements relating to "reserves" are forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the reserves described, as applicable, exist in the quantities predicted or estimated and can profitably be produced in the future. Undue reliance should not be placed on forward-looking statements, which are inherently uncertain, are based on estimates and assumptions, and are subject to known and unknown risks and uncertainties (both general and specific) that contribute to the possibility that the future events or circumstances contemplated by the forward-looking statements will not occur. There can be no assurance that the plans, intentions or expectations upon which forward-looking statements are based, will in fact be realized. Actual results will differ, and the difference may be material and adverse to the Company and its shareholders.

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

This MD&A contains information that may be considered a financial outlook or future-oriented financial information under applicable securities laws about the Company's potential financial position, including but not limited to: the expectation that the Marten Hills West natural gas tie-in infrastructure will cost $22.5 million; the Company's 2024 budget and guidance related to annual production, capital expenditures, dividends, adjusted funds flow from operations and adjusted working capital; the Company's future contractual obligations and commitments; and the estimated amount to settle the Company's decommissioning liabilities. Any financial outlook or future-oriented financial information in this MD&A, as defined by applicable securities legislation, has been approved by management of the Company as of the date hereof. Readers are cautioned that any such future-oriented financial information contained herein should not be used for purposes other than those for which it is disclosed herein. The Company and its management believe that the prospective financial information as to the anticipated results of its proposed business activities for the periods specified herein has been prepared on a reasonable basis, reflecting management's best estimates and judgments, and represent, to the best of management's knowledge and opinion, the Company's expected course of action. However, because this information is highly subjective, it should not be relied on as necessarily indicative of future results. The assumptions used in the 2024 guidance include: annual average production of 20,000 boe/d, WTI of US$75.30/bbl, WCS of Cdn$79.70/bbl, AGT US$5.05/mmbtu, AECO of Cdn$1.95/GJ, foreign exchange rate of Cdn$/US$ of 0.74, blending expense of WCS less $2.20, royalty rate of 18.8%, operating and transportation costs of $13.45/boe, G&A and interest income and other expense of $1.30/boe and cash taxes of $6.10/boe. The AGT price is the average price for the winter producing months in the McCully field which include January to April and November to December. 2024 annual production guidance comprised of: 18,650 bbls/d of heavy oil, 50 bbls/d of natural gas liquids and 7.8 mmcf/d of natural gas.

Since forward-looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to a number of factors and risks. These include, but are not limited to, the risks identified under the heading "*Business Conditions and Risks*". Further information regarding these factors and additional factors may be found under the heading "Risk Factors" in the Annual Informational Form for the year ended December 31, 2023, dated March 7, 2024, which is available on the Company's website at www.headwaterexp.com and under the Company's profile on SEDAR+ at www.sedarplus.com. Readers are cautioned that the foregoing list of factors that may affect future results is not exhaustive.

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

Corporate Information

Board of Directors

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

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

CHANDRA HENRY (1) (2)
CFO and Chief Compliance Officer, Longbow Capital Inc.
Calgary, Alberta

STEPHEN LARKE (2) (4)
Director, Vermillion Energy Inc. and Topaz Energy Corp.
Calgary, Alberta

PHILLIP KNOLL(3) (4)
Director, Altagas Ltd.
Calgary, Alberta

KEVIN OLSON (1) (3)
Independent Businessman
Calgary, Alberta

DAVE PEARCE (2) (3)
Deputy Chairman, Azimuth Capital Management
Calgary, Alberta

KAM SANDHAR (1)
Executive Vice President and CFO
Cenovus Energy Inc.
Calgary, Alberta

ELENA DUMITRASCU (4)
Cofounder and Chief Technology Officer, Credivera
Calgary, Alberta

DEVERY CORBIN (4)
Former Chief of Staff for the Mayor of the City of Calgary
Calgary, Alberta

(1) Audit Committee
(2) Corporate Governance and Compensation Committee
(3) Reserves Committee
(4) Environment, Safety and Sustainability Committee

Website: www.headwaterexp.com

Officers

NEIL ROSZELL, P. Eng.
Executive Chairman

JASON JASKELA, P. Eng.
President and CEO

ALI HORVATH, CPA, CA
Vice President Finance & CFO

GEORGIA LITTLE, CPA, CA
Interim Vice President Finance & CFO

TERRY DANKU, P. Eng.
Vice President Engineering

JON GRIMWOOD, P. Geo.
Vice President New Ventures

DIETER DEINES
Vice President Exploration

SCOTT RIDEOUT
Vice President Land

BRAD CHRISTMAN
Chief Operating Officer

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

Head Office
Suite 1400, 215 – 9th Avenue SW
Calgary, Alberta T2P 1K3
Tel: (587) 391-3680

Auditors
KPMG LLP
Calgary, Alberta

Independent Reservoir Consultants
McDaniel & Associates Consultants Ltd.