# Management's Report

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

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

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

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

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

(signed) "*Neil Roszell*"

Neil Roszell
Chief Executive Officer and Chairman

(signed) "*Ali Horvath*"

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

March 25, 2020

# Independent auditor's report

To the Shareholders of Headwater Exploration Inc.

## Our opinion

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Headwater Exploration Inc. (the Company) as at December 31, 2019 and 2018, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

**What we have audited**
The Company's financial statements comprise:

- the statements of financial position as at December 31, 2019 and 2018;
- the statements of income (loss) and comprehensive income (loss) for the years ended December 31, 2019 and 2018;
- the statements of cash flows for the years ended December 31, 2019 and 2018;
- the statements of changes in shareholders' equity for the years ended December 31, 2019 and 2018; and
- the notes to the financial statements, which include a summary of significant accounting policies.

## Basis for opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements* section of our report.

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

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

## Other information

Management is responsible for the other information. The other information comprise Management's Discussion and Analysis.

*PricewaterhouseCoopers LLP*
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*T: +1 902 491 7400, F: +1 902 422 1166*

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

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

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

## *Responsibilities of management and those charged with governance for the financial statements*

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

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

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

## *Auditor's responsibilities for the audit of the financial statements*

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Lee-Anne Kovacs.

(signed) *PricewaterhouseCoopers LLP*

**Chartered Professional Accountants**

Halifax, Nova Scotia
March 25, 2020

# HEADWATER EXPLORATION INC.
# Statements of Financial Position

| *(thousands)* | December 31, 2019<br>$ | December 31, 2018<br>$ |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash and cash equivalents | 60,957 | 53,652 |
| Restricted cash (note 18) | 680 | 650 |
| Accounts receivable (note 16) | 3,007 | 4,222 |
| Financial derivatives receivable (note 16) | 1,481 | 996 |
| Inventory held for sale | - | 16 |
| Prepaids and security deposits | 287 | 180 |
| Total current assets | 66,412 | 59,716 |
| Exploration and evaluation assets (note 5) | 3,816 | 3,451 |
| Property, plant and equipment (note 6) | 54,118 | 57,733 |
| Deferred Income tax assets (note 11) | 3,286 | 4,039 |
| Right-of-use assets (note 7) | 289 | - |
| Restricted cash (note 18) | 350 | 380 |
| Intangible assets | - | 7 |
| Total assets | 128,271 | 125,326 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current liabilities** | | |
| Accounts payable and accrued liabilities | 1,378 | 2,215 |
| Deferred share units liability (note 10) | 322 | 311 |
| Current portion of lease liability (note 7) | 90 | - |
| Total current liabilities | 1,790 | 2,526 |
| Lease liability (note 7) | 195 | - |
| Decommissioning liability (note 8) | 11,976 | 11,100 |
| Total liabilities | 13,961 | 13,626 |
| **Shareholders' Equity** | | |
| Capital stock (note 9) | 247,332 | 247,855 |
| Contributed surplus (note 10) | 11,366 | 11,048 |
| Deficit | (144,388) | (147,203) |
| Total shareholders' equity | 114,310 | 111,700 |
| Total liabilities and shareholders' equity | 128,271 | 125,326 |

Commitments (note 18)
Contingencies (note 19)
Subsequent events (note 20)

*See accompanying notes to the financial statements*

Approved by the board

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

(signed) "Neil Roszell"
Neil Roszell
Director

# HEADWATER EXPLORATION INC.
## Statements of Income (Loss) and Comprehensive Income (Loss)

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| *(thousands, except per share data)* | $ | $ |
| **REVENUE** | | |
| Sales (note 12) | 9,333 | 16,944 |
| Royalties | (230) | (506) |
| Revenue | 9,103 | 16,438 |
| Gains on financial derivatives (note 16) | 4,176 | 1,978 |
| Revenue and gains on financial derivatives | 13,279 | 18,416 |
| **EXPENSES** | | |
| Production | 2,611 | 2,739 |
| Transportation | - | 100 |
| General and administrative | 3,002 | 2,605 |
| Interest income and other (note 13) | (830) | (1,256) |
| Stock-based compensation (note 10) | 337 | 350 |
| Depletion, depreciation and amortization (notes 6 & 7) | 4,762 | 4,871 |
| Impairment losses (reversal) (notes 5 & 6) | (322) | 10,878 |
| Other write-downs and losses (note 6) | 151 | 52 |
| | 9,711 | 20,339 |
| **Income (loss) before income taxes** | 3,568 | (1,923) |
| **Deferred income tax expense (recovery)** | 753 | (1,609) |
| **Net income (loss) and comprehensive income (loss)** | **2,815** | **(314)** |
| Net income (loss) per share (note 9 (c)) | | |
| Basic | 0.03 | - |
| Diluted | 0.03 | - |

*See accompanying notes to the financial statements*

# HEADWATER EXPLORATION INC.
# Statements of Cash Flows

| **Cash flow related to the following activities:** | Year ended December 31, 2019 | 2018 |
|---|---|---|
| *(thousands)* | $ | $ |
| **OPERATING** | | |
| Net income (loss) | 2,815 | (314) |
| Items not involving cash: | | |
| Depletion, depreciation and amortization | 4,762 | 4,871 |
| Impairment losses (reversal) | (322) | 10,878 |
| Other write-downs and losses | 151 | 52 |
| Stock-based compensation | 337 | 350 |
| Unrealized gains on financial derivatives | (485) | (2,508) |
| Deferred income tax expense (recovery) | 753 | (1,609) |
| Accretion | 219 | 267 |
| Decommissioning liabilities settled | (24) | (1,755) |
| Change in non-cash operating working capital (note 15) | 655 | (117) |
| Cash flows provided by operating activities | 8,861 | 10,115 |
| **FINANCING** | | |
| Purchase of common shares under normal course issuer bid | (549) | - |
| Payment of lease liability | (148) | - |
| Proceeds from exercise of stock options | 18 | 102 |
| Cash flows provided by (used in) financing activities | (679) | 102 |
| **INVESTING** | | |
| Capital expenditures – property and equipment | (294) | (1,006) |
| Capital expenditures – exploration and evaluation | (391) | (1,248) |
| Proceeds on sale of assets | 97 | 1 |
| Change in non-cash investing working capital (note 15) | (289) | (489) |
| Cash flows used in investing activities | (877) | (2,742) |
| Change in cash and cash equivalents | 7,305 | 7,475 |
| Cash and cash equivalents, beginning of year | 53,652 | 46,177 |
| Cash and cash equivalents, end of year | 60,957 | 53,652 |

| | | |
|---|---|---|
| Cash and cash equivalents consist of: | | |
| Cash | 44,330 | 3,602 |
| Short-term investments | 16,627 | 50,050 |
| Cash and cash equivalents, end of year | 60,957 | 53,652 |

*See accompanying notes to the financial statements*

# HEADWATER EXPLORATION INC.
# Statements of Changes in Shareholders' Equity

| | Notes | Capital stock | Contributed surplus | Deficit | Total Shareholders' equity |
|---|---|---|---|---|---|
| *(thousands)* | | $ | $ | $ | $ |
| **Balance at January 1, 2018** | | **247,704** | **10,926** | **(146,889)** | **111,741** |
| Transfer of contributed surplus | 9(b) | 49 | (49) | - | - |
| Issued for cash on exercise of stock options | 9(b) | 102 | - | - | 102 |
| Stock-based compensation | 10(a) | - | 171 | - | 171 |
| Net loss | | - | - | (314) | (314) |
| **Balance at December 31, 2018** | | **247,855** | **11,048** | **(147,203)** | **111,700** |
| **Balance at January 1, 2019** | | **247,855** | **11,048** | **(147,203)** | **111,700** |
| Purchases through normal course issuer bid | | (549) | - | - | (549) |
| Transfer of contributed surplus | 9(b) | 8 | (8) | - | - |
| Issued for cash on exercise of stock options | 9(b) | 18 | - | - | 18 |
| Stock-based compensation | 10(a) | - | 326 | - | 326 |
| Net income | | - | - | 2,815 | 2,815 |
| **Balance at December 31, 2019** | | **247,332** | **11,366** | **(144,388)** | **114,310** |

*See accompanying notes to the financial statements*

# HEADWATER EXPLORATION INC.
# Notes to the Financial Statements

As at and for the years ended December 31, 2019 and 2018

*(All tabular amounts in thousands, unless otherwise stated)*

## 1. NATURE OF OPERATIONS

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

Headwater's principle place of business is located at 1700, 500 – 4$^{TH}$ Avenue S.W., Calgary, Alberta, T2P 2V6 and its registered office is located at 2400, 525 - 8$^{th}$ Avenue S.W., Calgary Alberta, T2P 1G1.

## 2. BASIS OF PREPARATION

*Statement of compliance*

These audited annual financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"). These accounting policies have been consistently applied for all periods presented in these financial statements.

These audited financial statements were approved and authorized for issue by the Company's Board of Directors on March 25, 2020.

*Basis of measurement, functional and presentation currency*

The audited financial statements have been prepared on the historical cost basis except derivative financial instruments and deferred share units are measured at fair value.

The methods used to measure fair values are discussed in note 3.

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

*Comparative Figures*

The Company has revised the classification of cash flows from decommissioning liabilities settled presented for comparative purposes to conform with the financial statement presentation for the current year.

*Use of estimates and judgments*

The preparation of the Company's financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions are evaluated at each reporting date and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Actual results may differ from the estimated amounts as future confirming events occur and more information is obtained by management. The Company has identified the following areas requiring significant judgments, assumptions or estimates.

a) 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 development and production asset carrying values is subject to management judgment. Judgments are made in regard to shared infrastructure, geographical proximity, petroleum type and similar exposure to market risk and materiality. The asset composition of a CGU can directly impact the recoverability of the assets included therein. The key estimates used in the determination of cash flows from oil and natural gas reserves include the following:

i) Reserves – assumptions that are valid at the time of reserve estimation may change significantly when new information becomes available. Changes in forward price estimates, production levels or results of future drilling may change the economic status of reserves and may ultimately result in reserves being restated.

ii) Oil and natural gas prices – forward price estimates are used in the cash flow model. Commodity prices can fluctuate for a variety of reasons including supply and demand fundamentals, inventory levels, exchange rates, weather, and economic and geopolitical factors.

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

Judgments are required to assess when impairment indicators exist and impairment testing is required. In determining the recoverable amount of assets, in the absence of quoted market prices, impairment tests are based on estimates of reserves, production rates, future oil and natural gas prices, future costs, discount rates, market value of land and other relevant assumptions.

*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 future events and circumstances 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 the CGU level.

*Deferred income taxes*

The recognition of deferred income tax assets is based on the probability that future taxable profits will be sufficient to utilize the underlying taxable amounts. Changes in the estimated future taxable profits could materially impact the Company's deferred income tax assets.

*Contingencies*

By their nature, contingencies will only be resolved when one or more future events occur or fail to occur. The assessment of contingencies inherently involves the exercise of significant judgment and estimates of the outcome of future events.

b) Key Sources of Estimation Uncertainty

*Recoverability of asset carrying value*

At each reporting date, the Company assesses its property, plant and equipment, oil and gas properties and exploration and evaluation assets to determine if there is any indication that the carrying amount of the assets may not be recoverable. An assessment is also made at each reporting date to determine whether there is any indication that previously recognized impairment losses no longer exist or have decreased. Determination as to whether and how much an asset is impaired, or no longer impaired, involves management estimates on highly uncertain matters such as future commodity prices, discount rates, production profiles, operating costs, future capital costs and reserves. Changes in circumstances may impact these estimates which may impact the recoverable amount of assets. Any change in the impairment loss or reversal of impairment loss could have a material financial impact in future periods.

*Valuation of Reserves*

Reserves estimates have a material impact on the depletion expense, impairment test calculation and decommissioning liability, all of which could have a material impact on financial results. The estimation of economically recoverable natural gas and oil reserves is based on a number of variable factors and assumptions, such as future production, ultimate reserve recovery, commodity prices, royalty rates, future costs and the timing and amount of capital expenditures, and the ability to undertake such expenditures in the future given the hydraulic fracturing moratorium in effect in New Brunswick. These reserve estimates are evaluated by third-party professional engineers at least annually, who work with information provided by the Company to establish reserve determinations in accordance with National Instrument (NI) 51-101, "Standards of Disclosure for Oil and Gas Activities". Accordingly, the impact to the financial statements in future years could be material.

*Decommissioning liability*

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.

*Valuation of derivative financial instruments*

The estimated fair values of derivative financial instruments resulting in financial assets and liabilities, by their very nature are subject to measurement uncertainty.

*Measurement of share-based compensation*

The estimated fair value of stock options uses pricing models such as the Black-Scholes model which is based on significant assumptions such as volatility, forfeiture rates and the expected term.

*Income taxes*

Tax interpretations, regulations and legislation in the various jurisdictions in which the Company operates are subject to change. As such, income taxes are subject to measurement uncertainty.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared by management using the following IFRS accounting policies. The accounting policies have been applied consistently for all periods presented in these financial statements. Certain prior year balances have been reclassified to be consistent with the current year's presentation.

a) Revenue recognition

*Natural gas and gas liquids*

Headwater delivers and sells its natural gas production daily from the McCully Field in New Brunswick to markets in northeastern United States and the Maritimes pursuant to long-term agreements with a marketing agent. The Company satisfies its performance obligations upon the delivery of the natural gas production. The transaction price is based on the daily commodity price adjusted for the delivery location and other seasonal factors based on the terms of the agreements. The fees associated with marketing and transportation services provided by the Company's marketing agent are deducted from the transaction price while transportation services procured by Headwater are recognized in transportation expenses. Headwater's natural gas revenues do not contain significant financing components and payments are typically due 25 days following the month of delivery.

Revenue from Headwater's working interest of natural gas production is recognized at the point in time when control of the natural gas is transferred, being when the natural gas has been delivered to Headwater's marketing agent at the agreed delivery location, which coincides with the month the natural gas is produced. Natural gas revenue is recognized at the agreed transaction price based on the terms of the agreements. Natural gas liquids revenue is recognized at the point in time when delivery has taken place.

*Gathering, processing and transportation fees*

The Company has collaborative arrangements with its joint venture partner, Nutrien Inc., (formerly Potash Corporation of Saskatchewan Inc.) ("Nutrien") to gather, process and transport Nutrien's working interest share of natural gas production from the McCully Field through Headwater's production facilities. The gathering, processing and transportation fees are calculated based on the use of these facilities and include a recovery of capital and a recovery of operating expenses.

Gathering, processing and transportation fees relating to the recovery of capital of Headwater's production facilities are recognized when the gathering, processing and transportation services have been provided to Nutrien, which coincides with the month the natural gas is produced.

b) Exploration and evaluation (E&E) assets

Once the legal right to explore has been acquired, costs directly associated with an exploration activity are capitalized as E&E intangible assets and grouped by licensed exploration area. Capitalized costs include lease acquisition costs, geological and geophysical expenses, the portion of general and administrative expenses and estimated decommissioning liabilities directly related to exploration activities and costs of drilling both productive and non-productive wells. Costs are capitalized until the technical feasibility and commercial viability of extracting a mineral resource are demonstrable and the presence of reserves has been established, after which capitalized costs are transferred to oil and gas properties following an assessment for impairment.

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

Exploration and evaluation assets are not depleted.

c) Property, plant and equipment

*Oil and gas properties*

Oil and gas properties are stated at cost, less accumulated depletion and impairment losses. The costs of drilling development wells, including unsuccessful development or delineation wells, are capitalized within oil and gas properties in property, plant and equipment. Capitalized costs consist of the purchase price or construction cost including any costs directly attributable to bringing the well into operation, the present value of the estimated decommissioning obligation and borrowing costs for qualifying assets.

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

*Production facilities*

The initial cost of production facilities consists of its purchase price or construction cost, the present value of the estimated decommissioning obligation and borrowing costs for qualifying assets.

*Inventories*

Inventories held for exploration and development activities are capitalized in property, plant and equipment and stated at the lower of cost and net realizable value. Cost is determined using the weighted average cost method. Net realizable value is the estimated selling price less applicable selling expenses.

*Depletion and depreciation*

Property, plant and equipment is carried at cost less accumulated depreciation and impairment losses, and is depreciated using the following methods and estimated useful lives:

| **Asset** | **Method** | **Basis** |
|---|---|---|
| Buildings | Declining Balance | 4% |
| Equipment and furniture | Declining Balance | 10% - 30% |
| Computer hardware and software | Declining Balance | 30% - 50% |
| Vehicles | Declining Balance | 30% |
| Midstream assets | Straight line | 5 – 15 years |
| Production facilities | Unit of Production | Proved reserves |
| Oil and gas Properties | Unit of Production | Proved reserves |

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

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

d) Impairment of non-financial assets

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

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

e) Intangible assets

Intangible assets consist of computer software and are carried at cost, less accumulated amortization and impairment losses. Intangible assets are depreciated on a straight-line basis over the estimated useful life of ten years.

f) Leases

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

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

The Company does not recognize assets and lease liabilities for short-term leases with a term of 12 months or less, and leases of low value assets. The lease payments associated with these leases are recognized as an expense in the Statement of Income and Comprehensive Income over the lease term.

g) Deferred taxes

Deferred income tax assets are recognized to the extent future recovery is probable using the liability method of accounting. Deferred income tax is recognized for the temporary differences between the tax basis and carrying value of assets and liabilities. Deferred income tax is measured using the enacted or substantively enacted tax rates expected to be in effect when the deferred income tax assets are estimated to be realized or the deferred income tax liabilities are estimated to be settled. The effect of a change in income tax rates that are substantively enacted is recognized in the Statement of Income and Comprehensive Income in the period the change occurs.

h) Joint arrangements

The nature of Headwater's joint arrangement with Nutrien is a joint operation. As of December 31, 2019, Headwater and Nutrien jointly own 22 of the 40 wells drilled in the McCully Field in New Brunswick. The Company therefore only accounts for its share of the jointly controlled assets and liabilities and its proportionate share of the revenues and expenses incurred in relation to the activities in the jointly held assets.

i) Share-based compensation

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

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

j) Earnings per share

Earnings per share amounts are calculated based on the weighted-average number of common shares outstanding during the year. Diluted earnings per share are calculated giving effect to the potential dilution that would occur if the stock options were exercised, using the treasury stock method. This method assumes that the proceeds received upon exercise of all outstanding stock options, with an exercise price below the average market price, would be used to repurchase the Company's common shares at the average market price for the period.

k) Foreign currency translation

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

l) Operating segment

In measuring performance, Headwater does not distinguish or group its operations on a geographic or any other basis, and accordingly, results have been aggregated into a single reportable segment.

m) Financial assets and liabilities

All financial instruments, including derivatives and embedded derivatives in certain contracts, must initially be recognized in the Statement of Financial Position at fair value which is based on the following hierarchy:

- Level 1 - quoted prices in active markets;
- Level 2 - internal models using observable market information as inputs; and
- Level 3 - internal models without observable market information as inputs.

Subsequent measurement of the financial instruments is based on their classification. Non-financial derivatives must be recorded at fair value in the Statement of Financial Position unless they are exempt from derivative treatment based upon expected purchase, sale or usage requirements. The Company has classified each financial instrument into the following categories:

i) Financial assets at amortized cost

Financial assets at amortized costs include accounts receivables. They are financial assets held to collect contractual cash flows that represent payments of principal and interest only. The carrying values of accounts receivable approximate their fair values because of their short term to maturity.

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

ii) Financial liabilities at amortized cost

Financial liabilities at amortized cost include accounts payable, accrued liabilities and lease liabilities. Accounts payable and accrued liabilities approximate their fair values because of their short term to maturity or because the interest rates approximate market rates at the end of the period.

iii) Fair value through profit or loss

The Company's financial derivatives receivable or liability is classified as fair value through profit or loss and is recognized at fair value based on quoted market prices at each reporting date. Financial derivatives receivable or liability is included in current assets or liabilities with any changes in fair value included in the Statement of Income and Comprehensive Income. The Company does not apply hedge accounting to its derivative instruments.

The Company's deferred share units liability is classified as fair value through profit or loss and is recognized at fair value based on quoted market prices at each reporting date. The fair value of the DSUs granted and changes in their fair value are recognized as share-based compensation expense on the Statement of Income and Comprehensive Income.

n) Provisions

*Decommissioning provision*

A decommissioning liability is recognized for the present value of the future cost of abandoning oil and gas wells and related production facilities and is calculated based on engineering estimates. A decommissioning liability is recognized only when a legal or constructive obligation exists. The liability is measured at each reporting date at the fair value of the estimated expenditures expected to settle the obligation using a current risk-free interest rate. An equivalent amount is capitalized as part of exploration and evaluation assets or property, plant and equipment and depleted along with the related asset.

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

*General*

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

## 4. SUMMARY OF CHANGES IN ACCOUNTING POLICIES AND DISCLOSURES

On January 1, 2019, the Company adopted IFRS 16 "Leases" ("IFRS 16") which replaces IAS 17 "Leases" ("IAS 17"). The Company applied the modified retrospective approach which does not require restatement of prior period financial information as the cumulative effect of applying the standard to prior periods is recorded as an adjustment to opening retained earnings. IFRS 16 requires the recognition of a right-of-use asset and lease liability on the Statement of Financial Position for most leases, however, leases relating to the exploration of natural gas and oil resources are excluded.

On transition to IFRS 16, the Company elected not to reassess whether a contract is, or contains, a lease and IFRS 16 was therefore only applied to contracts that were previously classified as operating leases under IAS 17. The Company did not have any leases that were classified as finance leases under IAS 17 as at December

31, 2018. The Company also applied the permitted practical expedient relating to the use of hindsight in determining the lease term when the contract contains options to extend or terminate the lease.

The reconciliation of lease commitments from December 31, 2018 to the lease liabilities as at January 1, 2019 is as follows:

| | January 1, 2019 |
|---|---|
| | $ |
| Operating lease commitments disclosed as at December 31, 2018 | 1,211 |
| Exclusion for leases to explore for natural gas | (972) |
| Practical expedient relating to lease term extension | 219 |
| Discounting, using weighted average incremental borrowing rate of 4.4% | (104) |
| Lease liabilities as at January 1, 2019 | 354 |

Management has identified right-of-use assets related to office space, vehicles and land surface rights relating to producing facilities. The Company elected to measure right-of-use assets at an amount equal to the lease liability of $354 thousand and therefore the adoption of IFRS 16 had no impact on the opening deficit as at January 1, 2019.

## 5. EXPLORATION AND EVALUATION (E&E) ASSETS

Reconciliation of movements in E&E assets:

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| Balance, beginning of year | 3,451 | 11,570 |
| Additions | 391 | 1,248 |
| Impairment losses | - | (11,408) |
| Changes in decommissioning liabilities | (26) | 2,041 |
| Balance, end of year | 3,816 | 3,451 |

For the year ended December 31, 2019, there were no indicators of impairment.

In 2018, the Company announced its decision to suspend any further capital spending on the Old Harry prospect and, as a result, impairment losses of $11,408 thousand were recognized for the year ended December 31, 2018.

## 6. PROPERTY, PLANT AND EQUIPMENT

Reconciliation of movements in property, plant and equipment:

| | Oil and gas properties | Production facilities | Inventory | Office and other assets | Total |
|---|---|---|---|---|---|
| Cost | $ | $ | $ | $ | $ |
| Balance at December 31, 2017 | 241,712 | 77,438 | 1,055 | 2,667 | 322,872 |
| Additions | 587 | 225 | 96 | 98 | 1,006 |
| Transfer from (to) current assets | 8 | 67 | 380 | (67) | 388 |
| Sale of assets | - | - | - | (3) | (3) |
| Changes in decommissioning liabilities | 2,018 | - | - | - | 2,018 |
| Balance at December 31, 2018 | 244,325 | 77,730 | 1,531 | 2,695 | 326,281 |
| Additions | 44 | 206 | - | 44 | 294 |
| Transfer from (to) current assets | - | - | (32) | - | (32) |
| Sale of assets | (48) | (15) | - | (55) | (118) |
| Changes in decommissioning liabilities | 707 | - | - | - | 707 |
| Balance at December 31, 2019 | 245,028 | 77,921 | 1,499 | 2,684 | 327,132 |
| | | | | | |
| Accumulated depletion and depreciation | | | | | |
| Balance at December 31, 2017 | 199,816 | 61,531 | 710 | 1,898 | 263,955 |
| Depletion or depreciation expense | 3,485 | 1,233 | - | 105 | 4,823 |
| Impairment reversal | (380) | (150) | - | - | (530) |
| Transfer from (to) current assets | - | 12 | 250 | (12) | 250 |
| Write-down and sale of assets | - | - | 52 | (2) | 50 |
| Balance at December 31, 2018 | 202,921 | 62,626 | 1,012 | 1,989 | 268,548 |
| Depletion or depreciation expense | 3,367 | 1,134 | - | 110 | 4,611 |
| Impairment reversal | (226) | (96) | - | - | (322) |
| Transfer from current assets | - | - | 57 | - | 57 |
| Sale of assets | - | - | - | (31) | (31) |
| Write-down of assets | - | - | 151 | - | 151 |
| Balance at December 31, 2019 | 206,062 | 63,664 | 1,220 | 2,068 | 273,014 |
| | | | | | |
| Net book value at December 31, 2018 | 41,404 | 15,104 | 519 | 706 | 57,733 |
| Net book value at December 31, 2019 | 38,966 | 14,257 | 279 | 616 | 54,118 |

The calculation of depletion includes estimated future development costs relating to the development of proved reserves of $2,643 thousand for the year ended December 31, 2019 (December 31, 2018 - $2,652 thousand).

*2019 Impairment Reversal*

For the year ended December 31, 2019, the Company reversed previously recognized impairment losses relating to the Company’s New Brunswick CGU. The New Brunswick CGU includes the McCully Field, a natural gas producing asset, and exploration and evaluation natural gas assets. The reversal of impairment losses of $322 thousand for the year ended December 31, 2019 were allocated to oil and gas properties and production facilities.

The reversal of impairment losses for the year ended December 31, 2019 resulted from an increase in natural gas reserves and was based on the difference between the carrying value of the New Brunswick CGU and its recoverable amount of $45.0 million. The recoverable amount was determined using fair value less costs to sell based on after-tax future net cash flows of proved plus probable reserves, using forecast prices and costs and a discount rate of 10%. The key values used to determine the recoverable amount are classified as level 2 and level 3 in the fair value hierarchy classifications (as disclosed in note 3).

For the year ended December 31, 2019, the Company utilized the following forecast prices in the fair value calculation:

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025-2030 | Thereafter |
|---|---|---|---|---|---|---|---|
| Algonquin city-gates ($US/mmbtu) | 3.40 | 3.65 | 3.86 | 4.05 | 4.15 | 4.23 - 4.67 | +2%/year |
| McCully ($CDN/mcf) | 4.36 | 4.65 | 4.85 | 5.10 | 7.18 | 7.82 - 8.41 | +2%/year |
| Exchange rate ($US/$CDN) | 0.76 | 0.77 | 0.79 | 0.79 | 0.79 | 0.79 | 0.79 |

The forecast McCully natural gas prices were calculated by adjusting the Algonquin city-gates natural gas prices to reflect the expected premiums received at Headwater's delivery point, transportation costs, if applicable, and heat content. The fair value calculation was based on the following proved plus probable natural gas reserves, as evaluated by GLJ Petroleum Consultants Ltd., the Company's independent reserves engineers:

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Proved plus probable natural gas reserves (bcf) | 22.1 | 22.2 |

The following table demonstrates the impact of a 1% change in the discount rate on the calculation of the reversal of impairment losses for the year ended December 31, 2019:

| | 1% rate increase | 1% rate decrease |
|---|---|---|
| Reversal of impairment (impairment) | $ (2,294) | $ 2,519 |

*2018 Impairment Reversal*

For the year ended December 31, 2018, the Company reversed previously recognized impairment losses relating to the Company's New Brunswick CGU. The reversal of impairment losses of $530 thousand for the year ended December 31, 2018 was allocated to oil and gas properties and production facilities.

The reversal of impairment losses for the year ended December 31, 2018 resulted from an increase in natural gas reserves and was based on the difference between the carrying value of the New Brunswick CGU and its recoverable amount of $48.8 million. The recoverable amount was determined using fair value less costs to sell based on after-tax future net cash flows of proved plus probable reserves, using forecast prices and costs and a discount rate of 10%. The key values used to determine the recoverable amount are classified as level 2 and level 3 in the fair value hierarchy classifications (as disclosed in note 3).

For the year ended December 31, 2018, the Company utilized the following forecast prices in the fair value calculation:

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024-2028 | Thereafter |
|---|---|---|---|---|---|---|---|
| Algonquin city-gates ($US/mmbtu) | 4.40 | 4.55 | 4.55 | 4.50 | 4.63 | 4.70 – 5.00 | +2%/year |
| McCully ($CDN/mcf) | 6.14 | 5.87 | 5.72 | 5.51 | 5.61 | 7.50 – 8.24 | +2%/year |
| Exchange rate ($US/$CDN) | 0.75 | 0.77 | 0.79 | 0.81 | 0.82 | 0.83 | 0.83 |

The forecast McCully natural gas prices were calculated by adjusting the Algonquin city-gates natural gas prices to reflect the expected premiums received at Headwater's delivery point, transportation costs, if applicable, and heat content. The fair value calculation was based on the following proved plus probable natural gas reserves, as evaluated by GLJ Petroleum Consultants Ltd., the Company's independent reserves engineers:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Proved plus probable natural gas reserves (bcf) | 22.2 | 22.5 |

The following table demonstrates the impact of a 1% change in the discount rate on the calculation of the reversal of impairment losses for the year ended December 31, 2018:

| | 1% rate increase | 1% rate decrease |
|---|---|---|
| Reversal of impairment (impairment) | $ (2,335) | $2,561 |

## 7. LEASES

Right-of-use asset

The following table reconciles the right-of-use asset by class as at December 31, 2019:

| | Office building | Land | Vehicles | Total |
|---|---|---|---|---|
| | $ | $ | $ | $ |
| Cost | | | | |
| Leases recognized at January 1, 2019 | 170 | 174 | 10 | 354 |
| Additions | - | - | 79 | 79 |
| Balance at December 31, 2019 | 170 | 174 | 89 | 433 |
| | | | | |
| Accumulated depreciation | | | | |
| Depreciation expense | 113 | 8 | 23 | 144 |
| Balance at December 31, 2019 | 113 | 8 | 23 | 144 |
| Net book value at December 31, 2019 | 57 | 166 | 66 | 289 |

Lease liability

The following table reconciles the changes in the lease liability as at December 31, 2019:

| | December 31, 2019 |
|---|---|
| | $ |
| Leases recognized at January 1, 2019 | 354 |
| Leases recognized during the year | 79 |
| Interest expense | 15 |
| Payment of lease liability | (163) |
| Lease liability, end of year | 285 |
| Current portion of lease liability | (90) |
| Non-current portion of lease liability | 195 |

The weighted average discount rate for the year ended December 31, 2019 was 3.8%. Payments under the Company's short-term leases were $169 thousand in 2019.

The future annual principal payments under the leases are as follows:

| | December 31, 2019 |
|---|---|
| | $ |
| 2021 | 28 |
| 2022 | 15 |
| 2023 | 6 |
| 2024 | 6 |
| Thereafter | 140 |
| Total | 195 |

## 8. DECOMMISSIONING LIABILITY

The change in the decommissioning liability is due to the following:

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| Balance, beginning of year | 11,100 | 8,529 |
| Change in discount rate | 874 | 519 |
| Change in estimate (1) | (193) | 3,540 |
| Liabilities settled | (24) | (1,755) |
| Accretion | 219 | 267 |
| Balance, end of year | 11,976 | 11,100 |

(1) Relates to changes in costs of future obligations.

The Company's decommissioning liabilities are based on the Company's net ownership in wells, the gas processing plant and transmission pipeline and management's estimate of costs to abandon and reclaim those wells, gas processing plant and transmission pipeline as well as an estimate of the future timing of these costs.

The Company has estimated the net present value of its total asset retirement obligations to be $11,976 thousand at December 31, 2019 (December 31, 2018 - $11,100 thousand). The total future undiscounted amount of estimated cash flows required to settle these obligations is $16,998 thousand (December 31, 2018 - $17,481 thousand). Management estimates the settlement of these obligations between 2020 and 2040. At December 31, 2019, a risk-free rate of 1.8% (December 31, 2018 – 2.2%) and an inflation rate of 2.0% (December 31, 2018 – 2.0%) were used to calculate the estimated fair value of the decommissioning liability.

## 9. CAPITAL STOCK

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

b) Issued and outstanding

| | December 31, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Number of shares | Amount | Number of shares | Amount |
| | | $ | | $ |
| Balance, beginning of year | 88,899 | 247,855 | 88,655 | 247,704 |
| Exercise of stock options | 25 | 26 | 244 | 151 |
| Cancellations under normal course issuer bid | (777) | (549) | - | - |
| Balance, end of year | 88,147 | 247,332 | 88,899 | 247,855 |

On August 23, 2018, the Company implemented a normal course issuer bid ("NCIB") pursuant to the rules of the Toronto Stock Exchange that allowed the Company to purchase, for cancellation, up to 6,803,118 common shares. The NCIB expired on August 22, 2019.

During the year ended December 31, 2019, the Company purchased and cancelled 777 thousand common shares for total consideration of $549 thousand. The total cost paid, including commissions and fees, was recognized directly as a reduction in shareholders' equity. Under the NCIB, all common shares purchased were cancelled.

c) Per share amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding. The reconciling item between the basic and diluted average common shares outstanding is in-the-money stock options. For the year ended December 31, 2019, stock options of 2,020 thousand (December 31, 2018 – 900 thousand) were excluded from the dilution calculation since the average market price for the year was lower than the exercise price.

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Weighted average shares outstanding | | |
| Basic | 88,472 | 88,700 |
| Diluted | 88,757 | 89,095 |

## 10. SHARE-BASED COMPENSATION

a) Stock options

The Company has a stock option plan under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. The stock option plan is limited to 8,262,513 common shares with no more than 5% being issued to any one officer, director or employee. On May 12, 2014, the Board of Directors determined that non-employee directors would no longer be eligible to receive stock option grants. The exercise price of each option is based on the market price for the common share on the close of the day prior to the date the option was granted. Options granted under the plan generally vest over a three-year period and expire five years after the grant date. Participants of the stock option plan can elect to surrender any vested option in exchange for a cash payment based on the difference between the market value of the common share and the exercise price of the option. The Board of Directors has the sole discretion to consent or deny this election. The following table summarizes the changes in the outstanding stock options:

| | December 31, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
| Options outstanding, beginning of year | 3,471 | $ 0.79 | 3,265 | $ 0.79 |
| Granted | 225 | $ 0.70 | 1,783 | $ 0.70 |
| Forfeited, cancelled or expired | (181) | $ 0.71 | (1,333) | $ 0.75 |
| Exercised [(1)] | (25) | $ 0.72 | (244) | $ 0.42 |
| Options outstanding, end of year | 3,490 | $ 0.79 | 3,471 | $ 0.79 |
| Options exercisable, end of year | 2,466 | $ 0.82 | 1,769 | $ 0.89 |

*(1) The Company's weighted average share price, at the date of exercise, for stock options exercised during the year ended December 31, 2019 was $0.76 per common share (year ended December 31, 2018 - $0.79 per common share).*

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

| | Year ended December 31, 2019 | Year ended December 31, 2018 |
|---|---|---|
| Weighted average fair value of options granted | $ 0.37 | $ 0.37 |
| Risk-free interest rate | 1.6% | 2.0% |
| Expected forfeiture rate | 6.7% | 7.0% |
| Expected life (years) | 4.5 | 4.0 |
| Expected volatility | 66% | 68% |

The range of exercise prices of stock options outstanding and exercisable as at December 31, 2019 is as follows:

| | Outstanding options | | | Exercisable options | |
|---|---|---|---|---|---|
| Exercise prices | Number of options outstanding | Weighted average remaining term (years) | Weighted average exercise price | Number of options exercisable | Weighted average exercise price |
| $ 0.40 - $ 0.99 | 2,590 | 2.6 | $ 0.63 | 1,566 | $ 0.58 |
| $ 1.00 - $ 1.24 | 900 | 0.1 | $ 1.24 | 900 | $ 1.24 |
| Total | 3,490 | 2.0 | $ 0.79 | 2,466 | $ 0.82 |

For the year ended December 31, 2019, the Company recorded stock-based compensation expense with an offsetting increase to contributed surplus of $326 thousand relating to the stock option plan (December 31, 2018 - $171 thousand).

b) Deferred share units

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

The following table summarizes the changes in the outstanding DSUs:

| | December 31, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Number of DSUs | Amount | Number of DSUs | Amount |
| | | $ | | $ |
| DSUs, beginning of year | 388 | 311 | 216 | 132 |
| DSUs granted during the year | 59 | 40 | 172 | 114 |
| Fair value adjustment during the year | - | (29) | - | 65 |
| DSUs, end of year | 447 | 322 | 388 | 311 |

The DSU liability as of December 31, 2019 of $322 thousand is based on a fair value of $0.72 per DSU, the Company's closing share price at December 31, 2019 (December 31, 2018 - $0.80 per DSU).

## 11. INCOME TAXES

Deferred income tax expense or recovery differs from the amount which would be obtained by applying the Canadian statutory income tax rates to the income (loss) before income taxes as follows:

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| Income (loss) before income taxes | 3,568 | (1,923) |
| Blended Canadian statutory tax rate | 29.0% | 29.3% |
| Expected income tax expense (recovery) | 1,035 | (563) |
| Increase (decrease) resulting from: | | |
| Non-deductible (non-taxable): | | |
| - unrealized financial derivatives gains | (141) | (735) |
| - share-based compensation | 98 | 103 |
| Write-up of deferred income tax assets | (260) | (402) |
| Originating temporary differences recorded at the future income tax rates expected to be in effect when realized | 21 | (12) |
| | 753 | (1,609) |

At December 31, 2019, the Company has $100 million of deductible temporary differences for which no deferred tax asset is recognized as management has determined it is not probable that there will be sufficient taxable profits from operations and sufficient reversal of taxable temporary differences to facilitate the utilization of the underlying tax-deductible amounts. In addition, the Company has $1,705 thousand of unrecognized investment tax credits which will expire between 2028 and 2035.

## 12. SALES

Headwater sells its natural gas production daily from the McCully Field in New Brunswick pursuant to long-term agreements with a marketing agent. The transaction price is based on the daily commodity price adjusted for the delivery location and other seasonal factors based on the terms of the agreements. The fees associated with marketing and transportation services provided by the Company's marketing agent are deducted from the transaction price while transportation services procured by Headwater are recognized in transportation expenses. Headwater's natural gas revenues do not contain significant financing components and payments are typically due within 25 days following the month-end.

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

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| | $ | $ |
| Natural gas sales | 8,767 | 16,360 |
| Gathering, processing and transportation fees | 459 | 507 |
| Natural gas liquids sales | 107 | 77 |
| | 9,333 | 16,944 |

## 13. INTEREST INCOME AND OTHER

Interest and other consist of the following:

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| | $ | $ |
| Interest and other income | 1,147 | 889 |
| Foreign exchange gains (losses) | (83) | 634 |
| Accretion | (219) | (267) |
| Interest on lease liability | (15) | - |
| | 830 | 1,256 |

## 14. EXPENSES BY NATURE

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

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| | $ | $ |
| Production | 770 | 681 |
| General and administrative | 1,248 | 1,027 |
| Stock-based compensation | 337 | 350 |
| | 2,355 | 2,058 |

## 15. SUPPLEMENTAL CASH FLOW INFORMATION

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| | $ | $ |
| Change in non-cash operating working capital: | | |
| Accounts receivable | 693 | (239) |
| Prepaids and security deposits | (12) | (80) |
| Accounts payable and accrued liabilities | (26) | 202 |
| | 655 | (117) |
| Change in non-cash investing working capital: | | |
| Accounts receivable | 522 | (31) |
| Accounts payable and accrued liabilities | (811) | (458) |
| | (289) | (489) |
| Interest received | 1,339 | 727 |

## 16. RISK MANAGEMENT

a) The Company is exposed to the following risks:

i) Commodity price risk

Headwater enters into financial derivative contracts and physical delivery contracts to manage the risks associated with fluctuations in natural gas prices. The Company does not use derivative financial instruments for speculative purposes.

*Financial derivatives*

The Company has the following outstanding financial derivative contracts as at December 31, 2019:

| Type | Period | Daily Volume | Price | Index |
|---|---|---|---|---|
| Swap | Jan. 1, 2020 to Mar. 31, 2020 | 2,500 mmbtu | US$9.00/mmbtu | AGT-daily (1) |
| Swap | Jan. 1, 2020 to Mar. 31, 2020 | 2,500 mmbtu | US$7.12/mmbtu | AGT-daily (1) |

(1) Algonquin city-gates

As security for these financial swaps, the bank has the authority to hold Headwater funds in the amount of US$11 million.

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

| | Year ended December 31, 2019 | 2018 |
|---|---|---|
| | $ | $ |
| Financial derivatives gains (losses): | | |
| - realized gains (losses) | 3,691 | (530) |
| - unrealized financial derivative gains | 485 | 2,508 |
| Financial derivatives gains | 4,176 | 1,978 |

The fair value of the financial derivatives receivable of $1,481 thousand as of December 31, 2019 is based on estimated future natural gas prices as of that date. When assessing the potential impact of natural gas price changes on the fair value of the financial derivative contracts outstanding as at December 31, 2019, a 10% increase in forecast natural gas prices would decrease the change in unrealized gains on financial derivatives by $327 thousand, while a 10% decrease in forecast natural gas prices would increase the change in unrealized gains on financial derivatives by $327 thousand.

*Physical delivery contracts*

The Company has no physical delivery contracts in place as at December 31, 2019.

ii) Foreign currency risk

The Company is exposed to fluctuations in the exchange rate between the Canadian dollar and the U.S. dollar. Natural gas prices, condensate prices and transportation expenses are based upon reference prices denominated in U.S. dollars, while the Company's remaining expenses are denominated in Canadian dollars. The Company does not have any derivative financial instruments in place to manage this risk.

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

| *(thousands of U.S. dollars)* | December 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| Cash | 509 | 1,134 |
| Accounts receivable | 3,166 | 3,320 |
| Financial instruments in U.S. dollars | 3,675 | 4,454 |

At December 31, 2019, a 5% decrease in the U.S. dollar relative to the Canadian dollar would have resulted in a decrease of approximately $170 thousand in the Company's net income (December 31, 2018 – $300 thousand increase in net loss) due to a decrease in the financial instruments denominated in U.S. dollars. Conversely, a 5% increase in the U.S. dollar relative to the Canadian dollar would have resulted in an increase of approximately $170 thousand in the Company's net income (December 31, 2018 – $300 thousand decrease in net loss).

iii) Credit risk

Headwater sells all its natural gas production to one large credit-worthy purchaser under normal industry payment terms. Headwater's receivables from joint venture partners are also subject to normal credit risks in the natural gas industry. At December 31, 2019, 100% of the Company's accounts receivables were outstanding for less than 30 days. The average expected credit loss on the Company's accounts receivable was 0% as at December 31, 2019. Trade receivables generally have a 30-day term and have all been collected subsequent to year-end. As at December 31, 2019, the Company's receivables consisted of $2,632 thousand (December 31, 2018 - $3,534 thousand) of trade receivables primarily from a natural gas purchaser, $276 thousand (December 31, 2018 - $398 thousand) from joint venture partners and $99 thousand (December 31, 2018 - $290 thousand) from interest receivables.

The cash equivalents consist mainly of guaranteed investment certificates held with banks with high credit-ratings assigned by international credit-rating agencies. Management believes the risk of loss is low.

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The following table details the contractual maturities of the Company's liabilities as at December 31, 2019:

| | Within 1 year | 1 to 4 years | Beyond 4 years |
|---|---|---|---|
| | $ | $ | $ |
| Accounts payable and accrued liabilities | 1,378 | - | - |
| Lease liability | 90 | 55 | 140 |
| Operating leases | 123 | 375 | 181 |
| Total | 1,591 | 430 | 321 |

At December 31, 2019, the Company was holding cash and cash equivalents of $60,957 thousand. Given the Company's available liquid resources and the Company's 2020 budget, management expects to have sufficient available funds to meet the current and foreseeable financial liabilities.

b) Management of capital

Management's objectives when managing capital are to provide an adequate return to its shareholders and to safeguard the Company's ability to obtain financing and have access to capital. In the management of capital, the Company includes shareholders' equity and cash and cash equivalents. To facilitate the management of its capital structure, the Company prepares annual expenditure and operating budgets that are updated as necessary depending on success factors, industry conditions and cash flow provided by operations. These annual and updated budgets are approved by the Board of Directors. Headwater has the ability to adjust its capital structure by making modifications to its capital expenditure program.

The Company has not paid or declared any dividends.

## 17. RELATED PARTY TRANSACTIONS

Remuneration of directors and senior management

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| Wages and benefits | 1,026 | 888 |
| Directors' compensation | 202 | 393 |
| Share-based compensation | 232 | 108 |
| | 1,460 | 1,389 |

Remuneration of directors and senior management includes all amounts earned and awarded to the Board of Directors and senior management. Wages and benefits include salary, bonuses and benefits during the year. Share-based compensation and directors' compensation includes expenses relating to Headwater's stock option plan and DSU plan as disclosed in note 10.

## 18. COMMITMENTS

a) Gas sales

The Company has a long-term agreement to sell, at market rates, all of its natural gas produced from the McCully Field and surrounding areas in southern New Brunswick to Repsol Oil & Gas Canada Inc. ("Repsol") for resale to natural gas markets in Maritimes Canada and the Northeast United States. The contract terminates on April 1, 2024.

b) Letters of credit

At December 31, 2019, the Company had the following irrevocable standby letters of credit issued by a Canadian chartered bank:

| | Amount |
|---|---|
| | $ |
| Letters of credit expiring June 3, 2020 | 300 |
| Letter of credit expiring July 15, 2020 | 380 |
| Letter of credit expiring June 27, 2020 – automatic renewal | 350 |
| | 1,030 |

The Company has pledged $1,030 thousand of short-term investments as security. These investments are recorded as restricted cash in current assets or non-current assets based on their expiry date.

c) Commitments

The maturities of the Company's commitments as of December 31, 2019 are as follows:

| | Total | 2020 | 2021 | 2022 | 2023 | Thereafter |
|---|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ | $ |
| Operating leases [1] [2] | 679 | 123 | 97 | 93 | 93 | 273 |
| Total | 679 | 123 | 97 | 93 | 93 | 273 |

(1) Payments under operating leases include leases related to the exploration of natural gas and oil resources and office rent. For the year ended December 31, 2019, the rent expense under these leases was $131 thousand (December 31, 2018 - $229 thousand).

(2) Excludes leases accounted for under IFRS 16. Refer to note 7.

## 19. CONTINGENCIES

During the year, the lawsuit brought by Geophysical Services Incorporated against Headwater in 2013 was dismissed by the Alberta Court of Queen's Bench by consent of the parties.

## 20. SUBSEQUENT EVENTS

a) Natural gas contracts

Financial derivative

Subsequent to December 31, 2019, the Company entered into a commodity contract for 2,500 mmbtu/d at a fixed price of US$5.45/mmbtu for February 2020.

Physical trade

Subsequent to December 31, 2019, the Company entered into a physical natural gas contract with Repsol for 5,000 mmbtu/d at US$2.40/mmbtu for April 2020.

b) Stock options

Stock option exercises

Subsequent to December 31, 2019, 1.8 million stock options were exercised for proceeds of $1.7 million.

Stock option grants

At a meeting of the Board of Directors held on March 25, 2020 the directors approved a grant of 1,200,000 stock options to purchase common shares to the non-management directors of the Company under the existing stock option plan of the Company (the "Existing Option Plan"). Pursuant to the stock option grant, each non-management director will be granted 200,000 stock options on March 27, 2020 with an exercise price based on the closing price of the common shares of the Company on the Toronto Stock Exchange on March 26, 2020. The stock options granted to the non-management directors vest as to one third of the number of stock options granted on each of the first, second and third anniversaries of the date of grant, respectively, and expire four years from the date of grant.

In addition, at the meeting of the Board of Directors held on March 25, 2020 the directors also approved a new stock option plan (the "New Option Plan"). Under the terms of the New Option Plan, an aggregate number of stock options equal to 8.0% of the aggregate number of issued and outstanding common shares less the aggregate number of options outstanding under the Existing Option Plan may be granted. No stock options granted under the New Option Plan will be exercisable until the Company receives approval of the New Option Plan from the shareholders of the Company in accordance with the rules of the Toronto Stock Exchange. A grant of an aggregate of 5,065,000 stock options to purchase common shares to certain officers, employees and contractors of the Company under the New Option Plan was also approved on March 25, 2020. The effective date of the grant of the majority of the stock options granted under the New Option Plan will be March 27, 2020 with an exercise price based on the closing price of the common shares of the Company on the Toronto Stock Exchange on March 26, 2020; provided that grants to certain new officers and employee will be deferred until the start date of such officers and employees with the exercise price based on the closing price on the trading day immediately prior to such start date. The stock options will vest as to one third of the number of stock options granted on each of the first, second and third anniversaries of the date of grant, respectively, and expire four years from the date of grant.

c) Recapitalization transaction

On March 4, 2020, the Company completed a recapitalization transaction (the "Recapitalization Transaction"), as further described in the Company's management information circular dated February 3, 2020. The Recapitalization Transaction involved the following:

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

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

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

- The Company also changed its name to Headwater Exploration Inc., which name change was also approved by shareholders of the Company at the special meeting held on March 4, 2020.

Headwater intends to use the proceeds of the private placements for acquisition, development and drilling opportunities. A total of approximately $4.4 million of transaction costs and approximately $1.9 million of share issue costs were incurred in relation to the Recapitalization Transaction. Included in transaction costs is approximately $1.2 million related to severances and $0.5 million related to the settlement of DSU's.

d) Commodity price volatility

Subsequent to year-end significant declines in the spot price for oil and gas and significant declines in the stock market have occurred for various reasons linked to the Coronavirus pandemic and other conditions impacting worldwide oil prices.

The Company determines the recoverable amount of its oil and gas properties using a fair value less costs to sell model. Subsequent declines in oil and gas prices have not been reflected in the determination of the recoverable amount of oil and gas properties at December 31, 2019 in accordance with IFRS. In particular, pricing assumptions used in the determination of the recoverable amount were based on forward expectations at December 31, 2019.

Impairment indicators for the Company's oil and gas properties could exist at March 31, 2020, if current conditions persist.