Pipestone Energy Corp.

Audited Consolidated Financial Statements

For the Year Ended December 31, 2019

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

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Pipestone Energy Corp.

Opinion

We have audited the consolidated financial statements of Pipestone Energy Corp. (the "Entity"), which comprise:

- the consolidated statements of financial position as at December 31, 2019 and December 31, 2018
- the consolidated statements of loss and comprehensive loss for the years then ended
- the consolidated statements of changes in equity for the years then ended
- the consolidated statements of cash flows for the years then ended
- and notes to the consolidated financial statements, including a summary of significant accounting policies

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

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

Basis for Opinion

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

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

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

Other Information

Management is responsible for the other information. Other information comprises:

- the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions.

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

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

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

We have nothing to report in this regard.

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

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards (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 Entity'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 Entity or to cease operations, or has no realistic alternative but to do so.

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

Auditors' Responsibilities for the Audit of the Financial Statements

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

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

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

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

We also:

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

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

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity'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 Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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

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

The engagement partner on the audit resulting in this auditors' report is Jason Stuart Brown.

KPMG LLP

Chartered Professional Accountants

Calgary, Canada
March 17, 2020

Pipestone Energy Corp.
Consolidated Statements of Financial Position

(amounts in thousands of Canadian dollars)

	Note	**December 31, 2019**	December 31, 2018
		$	$
Assets			
Current assets			
Cash and cash equivalents		**28,647**	20,438
Accounts receivable	4(c)	**22,368**	2,602
Commodity financial derivative instruments	4(e)	**330**	-
Prepaid expenses and deposits		**2,077**	744
Total current assets		**53,422**	23,784
Non-current assets			
Exploration and evaluation assets	6	**38,881**	6,742
Property and equipment	7(a)	**518,199**	183,333
Right-of-use assets	7(b)	**53,225**	-
Commodity financial derivative instruments	4(e)	**89**	-
Deferred financing		**-**	2,441
Total assets		**663,816**	216,300
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities	9	**59,071**	43,964
Interest rate financial derivative instruments	4(e)	**1,439**	1,548
Commodity financial derivative instruments	4(e)	**1,310**	-
Lease liabilities	11	**3,617**	-
Total current liabilities		**65,437**	45,512
Non-current liabilities			
Bank debt	10	**163,048**	53,436
Lease liabilities	11	**50,300**	-
Decommissioning provisions	12	**6,722**	2,085
Interest rate financial derivative instruments	4(e)	**-**	1,209
Deferred tax liabilities	17(b)	**8,234**	-
Total liabilities		**293,741**	102,242
Shareholders' Equity			
Share capital	13(b)	**379,469**	126,025
Warrants	5	**15,307**	-
Contributed surplus	14(e)	**1,251**	-
Deficit		**(25,952)**	(11,967)
Total shareholders' equity		**370,075**	114,058
Total liabilities and shareholders' equity		**663,816**	216,300

Commitments and contingencies (note 20)
Subsequent events (note 21)

Approved by the Board of Directors.

(Signed) "GR", Director (Signed) "BL", Director

See accompanying notes to the financial statements.

Pipestone Energy Corp.

Consolidated Statements of Loss and Comprehensive Loss

(amounts in thousands of Canadian dollars, except for per share amounts)

	Note	Years ended December 31, 2019	2018
		$	$
Revenue			
Sales of liquids and natural gas	15	**62,521**	1,628
Royalties		**(2,912)**	(137)
Liquids and natural gas revenue		**59,609**	1,491
Realized loss on commodity financial derivative instruments	4(e)	**(819)**	-
Unrealized loss on commodity financial derivative instruments	4(e)	**(891)**	-
Total revenue		**57,899**	1,491
Expenses			
Operating		**24,140**	337
Transportation		**7,156**	-
General and administrative		**8,875**	6,957
Share-based compensation	14	**754**	-
Exploration and evaluation	6	**3,315**	-
Depletion and depreciation	7	**17,971**	376
Transaction costs	5	**4,305**	2,536
Total expenses		**66,516**	10,206
Operating Loss		**(8,617)**	(8,715)
Realized loss on interest rate financial derivative instruments	4(e)	**(192)**	-
Unrealized gain (loss) on interest rate financial derivative instruments	4(e)	**1,318**	(316)
Financing income		**1,038**	325
Financing expense	16	**(18,660)**	(3,474)
Loss Before Income Taxes		**(25,113)**	(12,180)
Deferred income tax recovery	17(a)	**11,128**	58
Loss and Comprehensive Loss for the Year		**(13,985)**	(12,122)
Loss per Share			
Basic and diluted	13(c)	**(0.07)**	(0.22)

See accompanying notes to the financial statements.

Pipestone Energy Corp.
Consolidated Statements of Changes in Equity
(amounts in thousands of Canadian dollars)

	Note	Share capital	Warrants	Contributed surplus	Retained earnings (deficit)	Total
		$	$	$	$	$
Balance at January 1, 2018		88,025	-	-	155	88,180
Issuance of common shares for cash		38,000	-	-	-	38,000
Loss for the year		-	-	-	(12,122)	(12,122)
Balance at December 31, 2018		126,025	-	-	(11,967)	114,058
Issuance of common shares for cash	13(b)	47,000	-	-	-	47,000
Corporate acquisition	5	206,061	15,307	772	-	222,140
Exercise of stock options	13(b)	168	-	(168)	-	-
Share-based compensation	14	-	-	647	-	647
Employee share purchase plan	14	215	-	-	-	215
Loss for the year		-	-	-	(13,985)	(13,985)
Balance at December 31, 2019		**379,469**	**15,307**	**1,251**	**(25,952)**	**370,075**

See accompanying notes to the financial statements.

Pipestone Energy Corp.
Consolidated Statements of Cash Flows
(amounts in thousands of Canadian dollars)

	Note	Years ended December 31, 2019	2018
		$	$
Cash flows related to:			
Operating Activities			
Loss		**(13,985)**	(12,122)
Add (deduct) items not involving cash:			
Unrealized loss (gain) on interest rate financial derivative instruments	4(e)	**(1,318)**	316
Unrealized loss on commodity financial derivative instruments	4(e)	**891**	-
Share-based compensation	14	**754**	-
Exploration and evaluation	6	**3,315**	-
Depletion and depreciation	7	**17,971**	376
Deferred income tax recovery	17(a)	**(11,128)**	(58)
Non-cash financing expense	16	**6,288**	3,328
Adjusted funds flow from (used in) operations		**2,788**	(8,160)
Decommissioning provision costs incurred	12	**(3)**	-
Change in non-cash working capital	18	**7,777**	4,292
Cash from (used in) operating activities		**10,562**	(3,868)
Investing Activities			
Exploration and evaluation asset expenditures	6	**(1,131)**	(190)
Property and equipment expenditures	7	**(161,063)**	(109,074)
Property and equipment acquisitions	7	**(214)**	(1,098)
Proceeds on asset under construction	7	**13,967**	-
Corporate acquisition, cash acquired	5	**20,295**	-
Change in non-cash working capital	18	**(26,351)**	28,212
Cash used in investing activities		**(154,497)**	(82,150)
Financing Activities			
Issuance of common shares	13(b)	**47,108**	38,000
Advances of bank debt	10	**271,762**	51,641
Repayments of bank debt	10	**(163,048)**	-
Debt issuance costs	10	**(2,839)**	(1,500)
Principal portion of lease payments	11	**(839)**	-
Cash from financing activities		**152,144**	88,141
Increase in cash and cash equivalents		**8,209**	2,123
Cash and cash equivalents, beginning of year		**20,438**	18,315
Cash and cash equivalents, end of year		**28,647**	20,438

Supplemental cash flow information (note 18)

See accompanying notes to the financial statements.

1. Reporting entity and description of the business

Pipestone Energy Corp. ("Pipestone Energy" or the "Company") is engaged in the exploration for, and development and production of, oil and natural gas liquids (including condensate, butane and propane) herein collectively referenced as "Liquids" and natural gas in Western Canada, with substantially all of its activities and assets focused in the Montney resource play in Alberta. The Company's shares are listed on the TSX Venture Exchange (TSXV). The address and principal place of business of the Company is Suite 3700, 888 – 3rd Street S.W., Calgary, Alberta, T2P 5C5.

On January 4, 2019 the Company completed its reverse takeover of, and amalgamation with, Blackbird Energy Inc. (the "Corporate Acquisition"). Prior to the Corporate Acquisition, Pipestone Energy was a privately held entity, operating under the name Pipestone Oil Corp. ("Predecessor Pipestone"), incorporated under the Business Corporations Act (Alberta) and a wholly-owned subsidiary of Canadian Non-Operated Resources LP ("CNOR LP"), a privately held partnership formed under the laws of the Province of Alberta. At December 31, 2019, CNOR LP held approximately 55 percent of Pipestone Energy's issued and outstanding common shares. The comparative figures presented for 2018 are that of the predecessor company, Predecessor Pipestone.

2. Basis of preparation

Principles of consolidation

The consolidated financial statements include the accounts of Pipestone Energy and its wholly owned subsidiary, Pennant Energy Inc. All intercompany transactions, balances, and unrealized gains and losses from intercompany transactions are eliminated on consolidation. The Company conducts many of its liquids and natural gas production activities through jointly owned assets and the financial statements reflect only the Company's proportionate interest in such revenues, expenses, assets and liabilities.

Statement of compliance

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), interpretations of the International Financial Reporting Interpretations Committee (IFRIC), and Canadian generally accepted accounting principles (GAAP) as set out in Part 1 of the Chartered Professional Accountants Canada Handbook – Accounting.

The consolidated financial statements were approved and authorized for issuance by Pipestone Energy's Board of Directors (the "Board") on March 17, 2020.

Basis of measurement

The financial statements have been prepared on a historical cost basis, except for certain financial instruments, which are measured at fair value.

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

Use of estimates and judgments

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. These estimates are reviewed periodically and, as adjustments become necessary, are reported in the period in which they become known. By their nature, these estimates and related future cash flows are subject to measurement uncertainty, and the impact on future financial statements could be material. Significant estimates and judgments made by management in the preparation of the financial statements are outlined below:

a) Reserves

Reserve estimates, although not reported as part of the Company's financial statements, can have a significant effect on profit or loss, assets and liabilities because of their impact on depletion and depreciation, decommissioning provisions, deferred tax, asset impairments and business combinations. Independent petroleum reservoir engineers evaluate the Company's liquids and natural gas reserves annually. The estimation of reserves is a complex and inherently uncertain process requiring significant judgment. Estimates of economically recoverable liquids and natural gas reserves are based on several variables and assumptions, such as geo-scientific interpretation, production forecasts, current and estimated future commodity prices, costs and related future cash flows, all of which may vary considerably from actual results. These estimates are expected to be revised upward or downward over time, as additional information such as reservoir performance becomes available, or as economic conditions change.

b) Impairment

The valuation of the liquids and natural gas properties is based on management's best estimate of the future recoverability of these assets. Various estimates are required in assessing the potential impairment of costs capitalized. Consideration of impairment includes estimates relating to reserve quantities, overall costs, future cash flows, regulatory approval, timing, commodity prices, the general economic environment and the ability to finance future activities.

Evaluations of discounted future cash flows are conducted using pre-tax discount rates, which is common industry practice and used by the Company's independent petroleum reservoir engineers in preparing their reserve reports. Based on an asset's individual characteristics, other economic and operating factors are also considered, which may increase or decrease the implied discount rate. Changes in economic conditions could significantly change the estimated recoverable amount.

c) Exploration and evaluation (E&E) assets

The application of the Company's accounting policy for E&E expenditures requires judgment in determining whether future economic benefits are likely before activities have reached a stage at which technical feasibility and commercial viability can be reasonably determined. Factors such as drilling results, future capital programs, future commodity prices, future operating costs, as well as estimated economically recoverable reserves are considered.

d) Identification of cash-generating units (CGUs)

The Company's upstream assets are grouped into CGUs, defined as the lowest level of assets for which there is separately identifiable independent cash inflow. Pipestone Energy has a sole CGU. The classification and allocation of assets into CGUs requires significant judgment and interpretation. Factors considered in the classification include the integration among assets, shared infrastructure, the existence of common sales points, geography, geological structure and the manner in which management monitors and makes decisions about Pipestone Energy's operations. The recoverability of the Company's assets is assessed at the CGU level and, therefore, the particular classification of the CGUs could have a significant impact on impairment losses and reversals.

e) Decommissioning provisions

The decommissioning provision utilizes assumptions to estimate the future liability based on experience and current economic factors which management believes are reasonable. The actual cost of decommissioning, however, is uncertain and cost estimates may change in response to numerous factors including changes in environmental and regulatory requirements, technological advances, inflation and the timing of expected decommissioning and restoration. In addition, management determines the appropriate discount rate at the end of each reporting period. This discount rate, which is estimated by management as risk-free, determines the present value of the estimated future cash outflows required to settle the obligation and may change in response to numerous market and Pipestone Energy-specific factors.

f) Financial derivative instruments

The amounts recorded for the fair value of financial derivative instruments are based on estimates of future interest rates, commodity prices and the volatility in those variables.

g) Income tax

Tax interpretations, regulations and legislation in the jurisdiction in which the Company operates are subject to interpretations and changes. As such, income taxes are subject to measurement uncertainty. Assessing the recoverability of deferred tax assets requires the Company to make significant estimates relating to the expectations of future cash flows from operations, and the application of existing tax laws. To the extent that future cash flows and taxable income differ significantly from estimates, the Company's ability to realize the deferred tax assets or liabilities recorded at the balance sheet date could be affected. Additionally, changes in tax laws could limit the Company's ability to obtain future tax deductions.

h) Business combinations

Business combinations are accounted for using the acquisition method of accounting, in which the identifiable assets acquired, liabilities assumed and non-controlling interest, if any, are recognized and measured at their fair values estimated based on information available at the date of acquisition. The determination of fair value often requires management to make assumptions and estimates about future events. The assumptions and estimates with respect to determining the fair value of property and equipment and E&E assets acquired generally require the most judgment and include estimates of reserves acquired, forecast benchmark commodity prices and discount rates. Assumptions are also required to determine the fair value of decommissioning provisions associated with the acquired assets. Changes in any of the assumptions or estimates used in determining the fair value of acquired assets and liabilities could affect the amounts assigned to assets and liabilities. Future net profit or loss can be affected as a result of changes in future depletion and depreciation, or asset impairment.

i) Share-based compensation

The Company's share-based compensation expense relates to stock options, performance share units ("PSUs") and restricted share units ("RSUs") which may be granted to employees, officers, directors and consultants. Awards are measured at fair value on the date of grant and are expensed over their vesting periods under their terms. All share-based compensation plans are currently accounted for as equity-settled share-based compensation arrangements. Upon exercise, share-based compensation plans allow the holder of an award to purchase or receive common shares.

The fair value of stock options is determined using the Black-Scholes option pricing model. It employs estimates of future volatility in the Company's share price, expected lives of awards, the risk-free interest rate, and other relevant assumptions. Volatility is estimated to be a blend of the average price volatility of the Company's common shares subsequent to the January 4, 2019 Blackbird Energy Inc. acquisition (see note 5, below) and the average price volatility of common shares of a comparative group of companies over the preceding period equaling the expected lives of Pipestone Energy options. The fair value of PSUs and RSUs are based on the Company's 5-day volume-weighted average trading price on the TSXV prior to the date of grant. The primary non-market-based vesting condition for the Company's share-based compensation plans is continuous employment, with limited exceptions in the case of qualified retirement. An estimated forfeiture rate is applied to the valuation of all equity units over the vesting period and is subsequently adjusted to reflect the actual number of equity awards that ultimately vest.

PSUs may be granted with certain time and performance-based vesting conditions and potentially a performance multiplier that are determined by the Company's Board of Directors on the date of grant. If the Company satisfies these performance criterion, a pre-determined adjustment factor is applied to the vested PSUs at the end of the performance period, which is based on, among other things, the Company's relative total return to shareholders performance compared to a selected peer group. The fair value of the PSUs at the date of grant is adjusted to reflect the probability of possible market outcomes. If the actual market adjustment factor is higher or lower than estimated, the expense attributable to the original fair value estimate of the PSU grant is not adjusted.

When equity compensation units are exercised or released, the consideration received, if any, together with the expense previously recognized in contributed surplus, is recorded as an increase to share capital.

3. Significant accounting policies

The following significant accounting policies are presented to assist the reader in evaluating the financial statements:

a) New or amended standards adopted by the Company

IFRS 16, *Leases*

Effective January 1, 2019, Pipestone Energy adopted IFRS 16 using the modified retrospective approach. Under this approach, the Company has not restated comparatives for 2018, as permitted under the standard's specific transitional provisions. The reclassifications and the adjustments arising from the new leasing rules are therefore recognized on a go forward basis from January 1, 2019.

Practical expedients applied

In applying IFRS 16 for the first time, the Company has used the following practical expedients the standard permits:

1) Apply a single discount rate to a portfolio of leases with similar characteristics.
2) Account for leases with a remaining term of less than 12 months as at January 1, 2019 as short-term leases.
3) Account for lease payments as an expense and not recognize a right-of-use (ROU) asset if the underlying asset is of low dollar value. Low dollar leases are leases with payments related to assets with values less than US$5,000, if measured when new.
4) Apply hindsight in determining the lease term when the contract contains terms to extend or terminate the lease.

Adjustments recognized on adoption of IFRS 16

On adoption of IFRS 16, Pipestone Energy recognized lease liabilities in relation to leases which had previously been classified as "operating leases" under the principles of IAS 17, *Leases*. These liabilities were measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate.

For leases previously classified as finance leases, the entity recognized the carrying amount of the lease asset and lease liability immediately before transition as the carrying amount of the ROU asset and the lease liability at the date of initial application. The measurement principles of IFRS 16 are only applied after that date. This resulted in measurement adjustments of $44,000. The re-measurements to the lease liabilities were recognised as adjustments to the related ROU assets immediately after the date of adoption.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

The following table provides a reconciliation of the commitments as at December 31, 2018 to the Company's lease liabilities as at January 1, 2019:

	$
Firm gathering	107,086
Firm processing	122,156
Firm transportation	69,027
Commitments as at December 31, 2018	298,269
Add: field office lease	47
Less: agreements that do not contain a lease	(298,269)
	47
Impact of discounting	(3)
Lease liability recognized as at January 1, 2019	**44**

The ROU asset was measured on a retrospective basis as if the new rules had always been applied. There were no onerous lease contracts that would have required an adjustment to the ROU assets at the date of initial application.

The recognized ROU assets as at January 1, 2019 relate to a field office lease.

The change in accounting policy affected the following items in the statement of financial position on January 1, 2019:

	January 1, 2019
	$
ROU asset presented in property and equipment	44
Current lease liability	33
Long-term lease liability	11

When measuring lease liabilities for leases that were classified as operating leases, the Company discounted lease payments using its estimated incremental borrowing rate at January 1, 2019. The weighted-average rate applied was 8 percent.

Leasing accounting policy

The Company leases a field office, field equipment and corporate office space. Lease terms are negotiated on an individual basis and contain a wide range of terms and conditions. The lease agreements do not impose any covenants, but leased assets may not be used as security for borrowing purposes.

Until the 2018 financial year, leases of property, plant and equipment were classified as either finance or operating leases. Payments made under operating leases (net of any incentives received from the lessor) were charged to profit or loss on a straight-line basis over the period of the lease.

From January 1, 2019, leases are recognised as a ROU asset with a corresponding liability at the date on which the leased asset is available for use by the Company. Each lease payment is allocated between the liability and financing expense. The financing expense is charged to profit or loss over the lease period and results in a constant periodic rate of interest on the remaining balance of the liability for each period. The ROU asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

Assets and liabilities arising from a lease are initially measured on a present value basis. Lease liabilities include the net present value of the following lease payments:

- fixed payments, less any lease incentives receivable;
- variable lease payment that are based on an index or rate;
- amounts expected to be payable under residual value guarantees;
- the exercise price of a purchase option if the Company is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the Company exercising that option.

The lease payments are discounted using the interest rate implicit in the lease. If that rate cannot be determined, the Company's incremental borrowing rate is used, being the rate that the Company would have to pay to borrow the funds necessary to obtain an asset of similar value in a similar economic environment with similar terms and conditions. Generally, the Company uses its incremental borrowing rate as the discount rate.

ROU assets are measured at cost, comprising the following:

- the amount of the initial measurement of lease liability;
- any lease payments made at or before the commencement date less any lease incentives received;
- any initial direct costs; and
- restoration costs.

The lease liability is subsequently increased by the interest expense on the lease liability and decreased by the lease payment made. It is re-measured when there is a change in future lease payments arising from a change in an index or rate, a change in the estimate of the amount expected to be payable under a residual value guarantee or, as appropriate, changes in the assessment of whether a purchase or extension is reasonably certain to be exercised or a termination option is reasonably certain not to be exercised.

The Company has applied judgment to determine the lease term for lease contracts which include renewal options. The assessment of whether the Company is reasonably certain to exercise such options impacts the lease term, which significantly affects the amount of lease liabilities and ROU assets recognized.

Payments associated with short-term leases and leases of low-value assets are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of 12 months or less. Low-value assets comprise IT equipment and small items of office furniture.

Cash flows relating to leases are presented as follows:

- cash payments for the principal portion of the lease liabilities as cash from financing activities;
- cash payments for the interest portion as cash from operating activities, consistent with the presentation of interest payments; and
- short-term lease payments, payments for leases of low-value assets and variable lease payments that are not included in the measurement of the lease liabilities as cash from operating activities.

b) Cash and cash equivalents

Cash and cash equivalents consist of deposits held with banks, and term deposits and other similar short-term money market instruments with original maturities of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management are included as a component of cash and cash equivalents.

c) Jointly owned assets

Some of the Company's liquids and natural gas activities involve jointly owned assets and are conducted under joint operating agreements. The financial statements include the Company's proportionate interest in such revenues, expenses, assets and liabilities.

d) Exploration and evaluation (E&E) assets

All costs directly associated with the exploration and evaluation of liquids and natural gas reserves are initially capitalized. E&E costs are those expenditures for an area where technical feasibility and commercial viability have not yet been determined. These costs include licence acquisition, exploration, geological and geophysical activities, E&E drilling, sampling, appraisals, directly attributable overhead and administration expenses, and the decommissioning provision. Costs incurred prior to acquiring the legal rights to explore an area are charged directly to profit or loss as E&E expense.

E&E costs are subject to regular technical, commercial and management review to confirm the continued intent to develop the resources. When an area is determined to be technically feasible and commercially viable, the accumulated costs are transferred to property and equipment. When an area is determined not to be technically feasible and commercially viable or the Company decides not to continue with its activity, the unrecoverable costs are charged to profit or loss as depletion and depreciation expense. E&E assets are not amortized.

Exchanges or swaps that involve only E&E assets are accounted for at cost. Any gains or losses from the divestiture of E&E assets are recognized in profit or loss.

e) Property and equipment (P&E)

P&E are carried at cost less accumulated depreciation, depletion, and impairment.

Included in cost are the purchase price and the costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the Company's management. For liquids and natural gas properties, cost includes land acquisition costs, geological and geophysical expenditures, drilling costs, and the estimated costs of provisions for restoring and abandoning sites located on the asset in question. Costs incurred subsequent to the determination of technical feasibility and commercial viability are added to the cost base of the respective item of P&E when they increase the future economic benefits of that asset. The costs of regular service and maintenance are expensed in profit or loss in the period in which they occur.

Costs associated with office furniture and fixtures, leasehold improvements, office equipment, computer hardware and computer software are carried at cost and depreciated on a straight-line basis, at rates approximating the estimated service lives of the assets, between 20 percent and 55 percent per year.

Depletion, depreciation, and amortization

Depletion of liquids and natural gas properties within the sole Pipestone CGU is recognized using the unit-of-production method based on the Company's share of total proved plus probable liquids and natural gas reserves before royalties as determined by independent reservoir engineers. The reserve evaluation is based on an estimated remaining reserve life. Future development costs are included in costs subject to depletion. For purposes of the depletion calculation, proved plus probable liquids and natural gas reserves are converted to a common unit of measurement based on their relative energy content, with 6,000 standard cubic feet of natural gas equalling 1 barrel of liquids. Costs of major development projects are excluded from the costs subject to depletion until they are available for use.

Well equipment will be depleted using the unit-of-production method along with the related reserves when the assets are designed to have a life similar to the reserves of the related wells. When well equipment, including major components, have useful lives differing from those of the related wells, they are depreciated separately, on a straight-line basis over their estimated respective useful lives.

f) Impairment of assets

Financial assets

The Company recognizes loss allowances for expected credit losses (ECL) on its financial assets measured at amortized cost. Due to the nature of its financial assets, Pipestone Energy measures loss allowances at an amount equal to expected lifetime ECLs. Lifetime ECLs are the anticipated ECLs that result from all possible default events over the expected life of a financial asset. ECLs are a probability-weighted estimate of credit losses. Credit losses are measured as the present value of all cash shortfalls (i.e. the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the Company expects to receive). ECLs are discounted at the effective interest rate of the related financial asset. The Company does not have any financial assets that contain a financing component.

Non-financial assets

Non-financial assets are reviewed at the end of each reporting period for any indication that an asset may be impaired and, if so, the Company determines whether the asset is impaired by comparing the carrying amount to the estimated recoverable amount. E&E assets are also assessed for impairment when they are reclassified to P&E.

For the purpose of the impairment test, non-financial assets are grouped into the sole Pipestone CGU, which are the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The recoverable amount of a CGU is the higher of its fair value less costs of disposal (FVLCOD) and its value in use (VIU). For the purposes of testing for impairment, E&E assets are tested at the CGU level.

The Company determines VIU by estimating the future cash flows expected from the CGU, discounted at a rate which reflects the current market assessment of the time value of money and the risks specific to the CGU. FVLCOD is determined as the amount obtainable from the sale of the CGU in an arm's-length transaction between knowledgeable, willing parties, less the costs of disposal. The Company considers recent transactions for similar assets within the same industry as indicators of fair value. FVLCOD is based on the discounted after-tax cash flows of reserves and resources using forward prices and costs, consistent with the Company's independent petroleum reservoir engineers.

An impairment loss is recognized when the carrying amount of the CGU exceeds its recoverable amount. Impairment losses for a CGU are allocated first to any goodwill allocated to the CGU and then to the other assets of the group pro rata on the basis of the carrying amount of each of the group's assets. The reductions in carrying amounts are recognized in profit or loss in the period in which they occur.

At the end of each reporting period, the Company assesses whether there is evidence that an impairment loss recognized in prior periods, for assets other than goodwill, should be reduced because the asset's expected recoverable amount has increased since the impairment loss was recorded. Impairment losses against goodwill cannot be reversed. If circumstances have changed since the recognition of an impairment loss such that the loss has been reduced, the carrying amount of the CGU is increased to the revised estimate of its recoverable amount but never beyond the previous value, net of depletion and depreciation, if no impairment loss had been recognized for the asset in prior periods.

g) Decommissioning provisions

The Company recognizes provisions for legal, contractual or constructive liabilities relating to the dismantling and reclamation of E&E assets and P&E in the period in which the liability is incurred. The amount recognized is the best estimate of the decommissioning cost, discounted to its present value using a risk-free discount rate, and is added to the carrying amount of the related asset and depreciated or depleted on a unit-of-production or straight-line basis, depending on the asset. The decommissioning provision is increased over time, with the accretion recognized as a financing expense. The Company reviews the appropriateness of the provision at the end of each reporting period. Changes in the estimated timing, cost of decommissioning, or discount rate are recognized on a prospective basis with an adjustment to the provision and corresponding adjustment to the related asset. When incurred, the actual costs of decommissioning are charged against the accumulated liability.

h) Income taxes

Income tax expense consists of current and deferred taxes. The expense is recognized in profit or loss, except for income tax related to the components of equity, which in such cases is recognized in equity. Income taxes are provided for on a non-discounted basis at amounts expected to be paid using the tax rates and laws that have been enacted or substantively acted at the end of the reporting period.

Income taxes payable and receivable are obligations or claims for the current and prior periods to be paid to (or recovered from) taxation authorities that are outstanding at the end of the reporting period. Current tax is computed on the basis of taxable profit, which differs from net profit.

The Company uses the liability method of accounting for income taxes. Under this method, deferred income tax assets and liabilities are determined based on the difference between the carrying value and the tax basis of the assets and liabilities. Any changes in the net amount of deferred income tax assets and liabilities are determined using enacted or substantively enacted tax rates and laws that will be in effect when differences are expected to be reversed. Deferred income tax assets and unused tax losses are recognized to the extent that it is probable that the assets can be utilized. Deferred income tax assets and liabilities are only offset when they arise within the same entity and tax jurisdiction.

i) Revenue

The Company recognizes revenue from the sale of commodities, which include liquids and natural gas. Revenue is measured based on the consideration specified in a contract with a customer and excludes amounts collected on behalf of third parties. Pipestone Energy recognizes revenue when it transfers control of the commodity or service to a customer, which is when title passes from the Company to its customer, the risks and rewards of ownership of the commodity pass to the customer and Pipestone Energy has the right to payment.

Purchases and sales of products entered in contemplation of each other with the same counterparty are recorded on a net basis. Revenues associated with services provided as an agent are recorded as the services are provided.

The Company satisfies its performance obligations in contracts with customers upon the delivery of liquids and natural gas, which is generally at a point in time. Revenue represents the Company's share of commodity sales, net of royalty obligations to governments and other mineral interest owners. Pipestone Energy sells its production of liquids and natural gas pursuant to variable price contracts. The transaction price for variable price contracts is based on the commodity price, adjusted for quality, location and other factors. The amount of revenue recognized is based on the agreed upon transaction price, whereby any variability in revenue is related specifically to the Company's efforts to deliver production. The resulting revenue is allocated to the production delivered in the period during which the variability occurs. As a result, none of the Company's variable revenue is considered to be constrained.

The Company's revenue transactions do not contain significant financing components and payments are typically due within 30 days of revenue recognition. The Company does not adjust transaction prices for the effects of a significant financing component when the period between the transfer of the promised goods or services to the customer and payment by the customer is less than one year. The Company does not disclose or quantify information about remaining performance obligations that have an original expected duration of one year or less and it does not have any long-term contracts with unfulfilled performance obligations.

j) Financing expense

Financing expense comprises interest expense on borrowing, financing costs, and accretion of the discount on decommissioning provisions.

Borrowing costs incurred for the acquisition or construction of qualifying assets are capitalized during the period required to complete and prepare the assets for their intended use or sale. A qualifying asset is one that takes substantial time to get ready for use or sale.

When funds are borrowed specifically to finance a project, the amount capitalized represents the actual borrowing costs. When the funds used to finance a project form part of general borrowing, the amount capitalized is calculated using the weighted average of rates applicable to the Company's relevant general borrowing during the period.

All other borrowing costs are recognized in profit or loss in the period in which they are incurred, using the effective interest rate method.

k) Income (loss) per share

Basic per share amounts are computed by dividing the profit or loss by the weighted-average number of common shares outstanding during the period. The Company utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted-average number of shares is calculated assuming that proceeds arising from the exercise of options and other dilutive instruments where the market price exceeds option price are used to purchase, for cancellation, common shares of the Company at their average market price for the period. The weighted-average number of shares is then adjusted by the net change.

l) Financial instruments

Pipestone Energy's financial assets include cash and cash equivalents and accounts receivable. The Company's financial liabilities include accounts payable and accrued liabilities, bank debt, and financial derivative instruments.

Financial instruments are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets and liabilities are not offset unless the Company has the current legal right to offset and intends to settle on a net basis or settle the asset and liability simultaneously.

The Company characterizes its fair value measurements into a three-level hierarchy depending on the degree to which the inputs are observable, as follows:

- Level 1 inputs are quoted prices in active markets for identical assets and liabilities;
- Level 2 inputs are inputs, other than quoted prices included within Level 1, that are observable for the asset or liability either directly or indirectly; and
- Level 3 inputs are unobservable inputs for the asset or liability.

Classification and measurement of financial assets

The initial classification of a financial asset depends on the Company's business model for managing its financial assets and the contractual terms of the cash flows. There are three measurement categories into which the Company classified its financial assets:

- Amortized Cost: Includes assets that are held within a business model whose objective is to hold assets to collect contractual cash flows and its contractual terms give rise on specified dates to cash flows that represent solely payments of principal and interest;
- FVOCI: Includes assets that are held within a business model whose objective is achieved by both collecting contractual cash flows and selling the financial assets, where its contractual terms give rise on specified dates to cash flows that represent solely payments of principal and interest; or
- FVTPL: Includes assets that do not meet the criteria for amortized cost or FVOCI and are measured at fair value through profit or loss. This includes all derivative financial assets.

On initial recognition, the Company may irrevocably designate a financial asset that meets the amortized cost or FVOCI criteria as measured at FVTPL if doing so eliminates or significantly reduces an accounting mismatch. On initial recognition of an equity investment that is not held-for-trading, the Company may irrevocably elect to present subsequent changes in the investment's fair value in OCI. There is no subsequent reclassification of fair value changes to earnings following the derecognition of the investment. However, dividends that reflect a return on investment continue to be recognized in net earnings. This election is made on an investment-by-investment basis.

At initial recognition, the Company measures a financial asset at its fair value and, in the case of a financial asset not at FVTPL, including transaction costs that are directly attributable to the acquisition of the financial asset. Transaction costs of financial assets carried at FVTPL are recorded as an expense in net earnings.

Financial assets are reclassified after their initial recognition only if the business model for managing those financial assets changes. The affected financial assets will be reclassified on the first day of the first reporting period following the change in the business model.

A financial asset is derecognized when the rights to receive cash flows from the asset have expired or have been transferred and the Company has transferred substantially all the risks and rewards of ownership.

Derivative financial instruments

Derivative financial instruments are used to manage economic exposure to market risks relating to commodity prices and interest rates. Derivative financial instruments are not used for speculative purposes. Policies and procedures are in place with respect to required documentation and approvals for the use of derivative financial instruments. Where specific financial instruments are executed, the Company assesses, both at the time of purchase and on an ongoing basis, whether the financial instrument used in the particular transaction is effective in offsetting changes in fair values or cash flows of the transaction.

Risk management assets and liabilities are derivative financial instruments classified as measured at FVTPL unless designated for hedge accounting. Derivative instruments that do not qualify as hedges, or are not designated as hedges, are recorded using mark-to-market accounting whereby instruments are recorded in the balance sheet as either an asset or liability with changes in fair value recognized in profit or loss as a gain or loss on risk management. The estimated fair value of all derivative instruments is based on quoted market prices or, in their absence, third-party market indications and forecasts.

m) Share capital

Common shares are classified as equity. Incremental costs directly attributable to the issuance of common shares, stock options and warrants are recognized as a reduction to equity, net of any tax effects.

n) New or revised IFRS not yet adopted

There are no not-yet-effective IFRS or IFRIC interpretations that are expected to have a material impact on the Company.

4. Financial instruments and risk management

a) Risk management overview

The Company's activities expose it to a variety of financial risks including credit risk, liquidity risk and market risk. This note presents information about changes to the Company's exposure to each of these risks, its objectives, policies and processes for measuring and managing risk, and its management of capital during the period. Further quantitative disclosure is included throughout these financial statements. Pipestone Energy employs risk management strategies and policies to ensure its risk exposure is consistent with its business objectives and risk tolerance. While the Board of Directors has overall responsibility for Pipestone Energy's risk management framework, Pipestone Energy's management monitors the risks and administers the risk management measures.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

b) Fair value of financial instruments

The fair values of cash and cash equivalents, accounts receivable, derivative financial instruments and accounts payable and accrued liabilities approximate their carrying values due to the short-term maturity of those instruments.

Bank debt is carried at amortized cost. The fair value of the bank debt at December 31, 2019, based on a discounted cash flow model assuming an 8.3 percent effective interest rate, is approximately $163.0 million (December 31, 2018 – $54.3 million).

The fair value of financial derivatives, including risk management contracts, is determined by discounting the difference between the contracted interest rates and forward rate curves at the balance sheet date, using a risk-free interest rate adjusted for the Company's and the counterparty's non-performance risk (see also note 4(e)).

The significance of inputs used in making fair-value measurements is examined and the inputs are classified according to a fair-value hierarchy with three levels. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant inputs are observable, either directly or indirectly, and are based on valuation models and techniques in which the inputs are derived from quoted indices. Level 3 valuations are based on inputs that are unobservable but are significant to the overall fair value measurement.

Cash and cash equivalents are measured at fair value based on their Level 1 designation. Derivative financial instruments, including risk management contracts, are measured at fair value based on a Level 2 designation. The bank debt fair value is determined based on a Level 3 designation.

c) Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. The Company is exposed to credit risk with respect to accounts receivable, cash and cash equivalents, and risk management contracts if in an unrealized asset position.

Substantially all of the Company's accounts receivable are due from purchasers of Pipestone Energy's liquids and natural gas production, joint interest partners and government agencies, and are subject to normal industry credit risk. Receivables from liquids and natural gas marketers are normally collected on the 25th day of the month following production. Joint interest receivables are typically collected within one to three months flowing production. The Company mitigates the credit risk associated with the marketing of its liquids and natural gas production by establishing marketing relationships with large, credit-worthy purchasers. The Company has not experienced any collection issues with its marketers.

Significant changes in industry conditions and risks that weaken joint interest partners' ability to generate cash flow will increase collection risk. Pipestone Energy's management believes the risk is mitigated by the size and reputation of the companies to which the Company extends credit.

At December 31, 2019 and 2018, the Company's accounts receivable were comprised of:

As at December 31,	**2019**	2018
	$	$
Liquids and natural gas sales	**18,046**	50
Joint interest billings, GST and other	**4,322**	2,552
Accounts receivable	**22,368**	2,602

The Company considers all accounts receivable greater than 90 days to be past due. At December 31, 2019, $Nil is past due (December 31, 2018 – $Nil).

As at December 31, 2019, approximately 92 percent of the Company's accruals, joint operations and trade receivables were with investment grade counterparties, and over 90 percent were outstanding for less than 60 days. The Company expects to collect all outstanding receivables at December 31, 2019.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

The Company manages the credit exposure related to cash and cash equivalents by selecting financial institutions with high credit ratings and monitors all short-term deposits to ensure an adequate rate of return. The Company manages the credit exposure related to risk management contracts by ensuring the contracts are with counterparties that are financial institutions with high credit ratings. Given these credit ratings, management does not expect any financial institution counterparty to fail to meet its obligations.

d) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's goal is to meet its liabilities when due, and its management of liquidity is structured accordingly. The Company's liquidity is affected by various external events and conditions, including commodity price fluctuations.

The Company expects to repay its financial liabilities in the normal course of operations and to fund future operational, capital and other obligations through future operating cash flow, as well as future equity and debt financing. Refer to the Company's bank debt (note 10) for further details on available amounts under existing banking arrangements.

The timing of undiscounted cash flows relating to the financial liabilities outstanding at December 31, 2019 is outlined below:

	1 year	2 years	3 years	>3 years	Total
	$	$	$	$	$
Accounts payable and accrued liabilities	59,071	-	-	-	59,071
Interest rate financial derivative instruments	1,439	-	-	-	1,439
Commodity financial derivative instruments	1,310	-	-	-	1,310
Bank debt [1]	-	163,048	-	-	163,048

[1] Excludes future interest payable on amounts drawn on the bank debt.

The Company is also subject to lease liabilities as disclosed in note 11 and commitments as disclosed in note 20.

The Company as indicated above has significant financial liabilities and commitments over the next one to two years. The Company believes in the near-term that its financial requirements will be met through its operating cash flow and its lending arrangements (note 10). While the Company believes it will be successful in meeting its liquidity requirements, uncertainty remains due to volatility in commodity prices; future reserve and production risks; changes in the overall economic environment; and the ability of the Company, if required; to raise additional debt or equity financing.

e) Market risk

Market risk is the risk that changes in market prices, such as commodity prices, interest rates and foreign exchange rates, will reduce the Company's net income or the value of financial instruments. These risks are largely outside the Company's control. The Company's objective is to manage and mitigate market risk exposure within acceptable limits, while maximizing returns. Market risks are as follows:

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

Foreign currency risk

Crude oil prices are determined in global markets and generally denominated in United States dollars. Natural gas prices obtained by the Company are influenced by U.S. and Canadian supply and demand and, to a much lesser degree, the international market for liquefied natural gas. An increase in the value of the Canadian dollar relative to the U.S. dollar will decrease the revenues received from the sale of liquids and natural gas. The impact of such exchange rate fluctuations cannot be predicted. At December 31, 2019 and December 31, 2018, the Company had no forward exchange rate contracts nor any working capital denominated in foreign currencies.

Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate because of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears variable rates of interest. The Company has two separate floating-to-fixed interest rate swaps in place with one of its lenders at December 31, 2019 (see note 10).

Reconciliation of changes of fair value in Pipestone Energy's interest rate financial derivative instruments:

Years ended December 31,	**2019**	**2018**
	$	$
Fair value of contracts, beginning of year	**(2,757)**	-
Contracts entered into	**-**	(2,441)
Change in fair value of contracts	**1,318**	(316)
Fair value of contracts, end of year	**(1,439)**	**(2,757)**
Current liability	**(1,439)**	(1,548)
Long-term liability	**-**	(1,209)

For the year ended December 31, 2019, a 1 percent fluctuation in interest rates would impact profit or loss by $0.7 million (year ended December 31, 2018 – $Nil). The Company had interest rate swaps or contracts during the year ended December 31, 2018 that completely hedged its interest rate exposure. Pipestone Energy recognized an unrealized gain on its interest rate financial derivative instruments of $1,318,000 for the year ended December 31, 2019 (year ended December 31, 2018 – loss of $316,000).

Commodity price risk

The Company's operations expose it to fluctuations in commodity prices. Commodity prices for liquids and natural gas are affected by both global economic events and North American specific factors that influence supply and demand. Pipestone Energy's management continuously monitors commodity prices.

The Company's policy is to limit swap commodity price contracts to approximately 50 percent of forecasted production volumes. The Company may also enter into other derivative financial instruments to achieve this objective. Collars (which are generally fee-offsetting put and call options for the same volume and time-frame) ensure that the realized commodity prices will fall into a contracted range for a contracted sale volume based on the monthly index price, while puts ensure the realized price will not fall below a price floor. The purchase of put options creates a floor for the realized price, while maintaining exposure to potential price upside.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

The following table summarizes the carrying value of Pipestone Energy's outstanding commodity financial derivative instrument assets (liabilities):

As at December 31,	**2019**	2018
	$	$
Condensate	**(2,663)**	-
Natural gas	**(1,320)**	-
Crude oil	**3,092**	-
Net commodity financial derivative instrument liability	**(891)**	-

The Company has offset the following commodity financial derivative instruments where it has a legal right to settle on a net basis with its counterparties:

As at December 31,	**2019**			2018		
	$	**$**	**$**	$	$	$
	Asset	**Liability**	**Net**	Asset	Liability	Net
Current asset	**2,206**	**(1,876)**	**330**	-	-	-
Long-term asset	**93**	**(4)**	**89**	-	-	-
Current liability	**1,359**	**(2,669)**	**(1,310)**	-	-	-
Net position	**3,658**	**(4,549)**	**(891)**	-	-	-

At December 31, 2019, Pipestone Energy had the following weighted-average condensate, crude oil and natural gas commodity financial derivative instruments:

	C$ WTI collars		**C$ WTI swaps**		**EdCon basis swaps**		**AECO 5A swaps**	
Term	**bbls/d**	**C$/bbl**	**bbls/d**	**C$/bbl**	**bbls/d**	**US$/bbl**	**GJ/d**	**C$/GJ**
Jan. – Mar. '20	731	70.47 – 80.45	2,800	79.11	3,000	(4.95)	31,647	1.94
Apr. – Jun. '20	500	73.00 – 81.60	2,800	79.11	2,000	(5.63)	40,000	1.60
Jul. – Sept. '20	-	-	3,400	78.15	1,000	(5.75)	40,000	1.60
Oct. – Dec. '20	-	-	2,750	77.90	1,000	(5.75)	28,396	1.65
Jan. – Dec. '21	-	-	-	-	-	-	2,500	1.95
Jan. – Dec. '22	-	-	-	-	-	-	2,500	1.95

(1) Weighted-average volumes and prices are presented.

(2) EdCon refers to Edmonton Condensate.

Reconciliation of changes of fair value in Pipestone Energy's risk management contracts:

Years ended December 31,	**2019**
	$
Fair value of contracts, beginning of year	-
Change in fair value of contracts	(891)
Fair value of contracts, end of year	**(891)**

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

Commodity price sensitivities – risk management positions

The following summarizes the sensitivity of the fair value of Pipestone Energy's risk management contracts to fluctuations in commodity prices, with all other variables held constant. Management believes the price fluctuations identified below are a reasonable measure of volatility. Fluctuating commodity prices could have resulted in unrealized gains or losses on the Company's risk management contracts at December 31, 2019, affecting profit or loss for the year ended December 31, 2019 as follows:

Commodity	Sensitivity range	Increase	Decrease
		$	$
Crude oil	± Cdn$1 per bbl – WTI NYMEX	(995)	995
Condensate	± Cdn$1 per bbl – Edmonton Condensate	(406)	406
Natural gas	± Cdn$0.10 per GJ – AECO 5A	(1,345)	1,345

f) Capital management

The Company considers its capital structure to include shareholders' equity, bank debt and adjusted working capital. The balance of each of these items is as follows:

As at December 31,	2019	2018
	$	$
Adjusted working capital deficit (1)	**5,979**	20,180
Bank debt	**163,048**	53,436
Net debt	**169,027**	73,616
Shareholders' equity	**370,075**	114,058
Total capitalization	**539,102**	187,674

(1) Adjusted working capital deficit is calculated as accounts payable and accrued liabilities, less cash and cash equivalents, accounts receivable, and prepaid expenses and deposits.

The Company maintains a flexible capital structure to maximize its ability to pursue liquids and natural gas exploration and asset acquisition opportunities and to sustain future development of the business.

The Company monitors capital based on its current working capital, projected cash flow from operations and anticipated capital expenditures. In order to manage its capital structure, the Company prepares annual capital expenditure and operating budgets, which are updated throughout the year as necessary. The annual and updated budgets are prepared by management and approved by the Board of Directors. Results are regularly reviewed and updated as required.

In order to maintain or adjust its current and projected capital structure, the Company may in the future issue equity, seek debt financing and/or adjust its capital spending. The Company's ability to raise additional debt or equity is affected by external conditions, including future commodity prices, and by global economic conditions. The Company continually monitors business conditions, including: changes in economic conditions, the risks encountered in its drilling programs, forecast commodity prices, and potential corporate or asset acquisitions.

The Company has no externally imposed formal capital requirements. The Company has not paid or declared any dividends. Other than the new debt entered on December 12, 2019 (note 10) there were no changes to the Company's approach to capital management during the year ended December 31, 2019.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

5. Corporate acquisition

On January 4, 2019 the Company completed an arrangement with Blackbird Energy Inc. ("Blackbird") providing for the combination of Blackbird and Predecessor Pipestone (the "Corporate Acquisition"), under the name Pipestone Energy Corp. ("Pipestone Energy"). The substance of the Corporate Acquisition is a go-public reverse takeover of Blackbird, a publicly traded company listed on the TSXV.

The reverse takeover involved a business combination of Blackbird and Predecessor Pipestone which formed a new amalgamated corporation, Pipestone Energy, which carries on Predecessor Pipestone's and Blackbird's combined businesses. Pursuant to the Corporate Acquisition, Blackbird acquired all issued and outstanding shares of the Company at an exchange ratio of 0.5996 Blackbird shares to one Predecessor Pipestone share. This resulted in Blackbird issuing 1,037,500,000 common shares to Predecessor Pipestone's shareholder. Blackbird shares were then converted to 0.1 common shares of Pipestone Energy upon amalgamation, which resulted in Predecessor Pipestone's shareholder holding 103,750,000 common shares (approximately 55 percent) and Blackbird shareholders holding 85,858,516 common shares (approximately 45 percent) of Pipestone Energy. The common shares of Pipestone Energy began trading on the TSXV in substitution of the common shares of Blackbird on January 9, 2019 under the trading symbol "PIPE".

Concurrently with the Corporate Acquisition, Blackbird and Predecessor Pipestone entered into agreements with certain of their existing shareholders who committed to common equity financing totaling $111.0 million, which was completed prior to closing. No finder's fees or commissions were payable with respect to the equity financing.

In conjunction with the closing, Pipestone Energy entered into a $198.5 million first lien credit facility (note 10).

The Corporate Acquisition was accounted for as a business combination under IFRS 3, *Business Combinations*, using the acquisition method. Predecessor Pipestone was considered the accounting acquirer of Blackbird and the assets acquired and liabilities assumed of Blackbird are recorded at their fair values as at January 4, 2019. The value attributed to the assets acquired is as follows:

	$
Fair value of assets acquired and liabilities assumed	
Cash and cash equivalents	20,295
Working capital deficit excluding cash and cash equivalents	(12,582)
Exploration and evaluation assets (note 6)	36,942
Liquids and natural gas interests (note 7)	197,755
ROU assets	1,630
Lease liability	(1,630)
Decommissioning provisions (note 12)	(908)
Deferred income taxes	(19,362)
Total assets acquired and liabilities assumed	**222,140**
Consideration	
Warrants [(1)]	15,307
Stock options [(1)]	772
Share consideration	206,061
Total purchase price	**222,140**

(1) Following closing of the Corporate Acquisition, each Blackbird warrant and stock option is exercisable for 0.1 of a common share of Pipestone Energy.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

Share consideration was based on 858,585,668 common shares of Blackbird at January 4, 2019 (85,858,516 based on the 10:1 share consolidation) with a closing price of $0.24 per share. Warrant consideration was based on 175,188,092 Blackbird warrants at January 4, 2019 with a closing price of $0.09 per warrant. On January 4, 2019 there were 35,477,945 Blackbird stock options outstanding (3,547,793 based on the 10:1 share consolidation) continued as part of the Corporate Acquisition.

These consolidated financial statements include the results of operations of Blackbird for the period following closing of the Corporate Acquisition on January 4, 2019. For the year ended December 31, 2019, the acquisition contributed revenues of approximately $13.2 million, royalties of approximately $0.7 million and operating expenses of approximately $7.8 million. As a result of the proximity of the closing to the start of 2019, these figures are materially the same as though the acquisition had occurred on January 1, 2019.

Acquisition-related costs of $2.5 million were incurred in the year ended December 31, 2018. These were expensed in profit or loss as transaction costs. During the year ended December 31, 2019 Pipestone Energy incurred an additional $4.3 million of acquisition-related costs that were expensed in profit or loss as transaction costs.

6. Exploration and evaluation (E&E) assets

Years ended December 31,	**2019**	2018
	$	$
Balance, beginning of year	**6,742**	8,648
Additions	**1,131**	190
Expiries	**(3,315)**	-
Corporate acquisition (note 5)	**36,942**	-
Transfers to P&E (note 7)	**(2,619)**	(2,096)
Balance, end of year	**38,881**	**6,742**

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

7. Property and equipment (P&E) and ROU assets

a) P&E

The Company's P&E is comprised of the following:

	Liquids and natural gas interests	Corporate and other	Total
	$	$	$
Cost			
Balance, January 1, 2018	70,536	-	70,536
Additions	108,951	123	109,074
Acquisitions	1,098	-	1,098
Transfers from E&E (note 6)	2,096	-	2,096
Decommissioning provision (note 12)	1,145	-	1,145
Balance, December 31, 2018	183,826	123	183,949
Additions	160,445	618	161,063
Transfer to assets under construction	(13,967)	-	(13,967)
Corporate acquisition (note 5)	197,755	-	197,755
Property acquisition	214	-	214
Transfers from E&E (note 6)	2,619	-	2,619
Decommissioning provisions (note 12)	3,622	-	3,622
Balance, December 31, 2019	**534,514**	**741**	**535,255**
Accumulated depletion and depreciation			
Balance, January 1, 2018	240	-	240
Depletion and depreciation	351	25	376
Balance, December 31, 2018	591	25	616
Depletion and depreciation	16,370	70	16,440
Balance, December 31, 2019	**16,961**	**95**	**17,056**
Balance, December 31, 2018	183,235	98	183,333
Balance, December 31, 2019	**517,553**	**646**	**518,199**

Pipestone Energy capitalized direct general and administrative expenses of $3.4 million during the year ended December 31, 2019 (year ended December 31, 2018 – $Nil).

Future capital costs required to develop proved plus probable reserves in the amount of $1,114.0 million (December 31, 2018 – $911.5 million) are included in the depletion calculation for liquids and natural gas interests. Pipestone Energy has a sole P&E CGU.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

b) ROU assets

The Company's ROU assets are comprised of the following lease categories:

	Office leases	Field equipment leases	Compressor lease	Total
	$	$	$	$
Cost				
Balance, January 1, 2019 (note 3)	44	-	-	44
Additions	1,492	-	51,590	53,082
Corporate acquisition (note 5)	-	1,630	-	1,630
Balance, December 31, 2019	1,536	1,630	51,590	54,756
Accumulated depreciation				
Balance, January 1, 2019	-	-	-	-
Depreciation	187	483	861	1,531
Balance, December 31, 2019	187	483	861	1,531
Carrying amount				
Balance, January 1, 2019	-	-	-	-
Balance, December 31, 2019	**1,349**	**1,147**	**50,729**	**53,225**

8. Impairment

At December 31, 2019, the Company reviewed for indicators of impairment to ensure that the carrying value of its property and equipment are recoverable. As at December 31, 2019, there were no indicators of impairment.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

9. Accounts payable and accrued liabilities

As at December 31,	2019	2018
	$	$
Accruals	43,019	25,281
Trade	14,521	18,531
Other	1,531	152
Total accounts payable and accrued liabilities	**59,071**	**43,964**

10. Bank debt

Years ended December 31,	2019	2018
	$	$
Balance, beginning of year	53,436	-
Increase in borrowing	100,000	51,641
Interest added to principal	8,714	2,693
Debt issuance costs, deferred financing	(2,441)	-
Debt issuance costs, cash	(2,839)	(1,500)
Amortization of debt issuance costs	6,178	602
Balance, end of year	**163,048**	**53,436**
Current portion	**-**	**-**
Long-term portion	**163,048**	**53,436**

On December 12, 2019, Pipestone Energy entered into a $225.0 million reserve-based loan (the “RBL”) comprised of a $195.0 million syndicated facility (the “Syndicated Facility”) and a $30.0 million operating facility (the “Operating Line”). The Syndicated Facility includes an accordion feature, which provides for a $25.0 million increase to the borrowing capacity, subject to the mutual consent of its lenders.

At December 31, 2019, the Company had $150.0 million drawn against the Syndicated facility and $13.0 million drawn on the Operating Line.

In addition to the balance of $163.0 million, the Company had $14.1 million in outstanding letters of credit issued against its Operating Line which reduces the available funding on the Operating Line.

The borrowing base on the facility will be redetermined bi-annually in the spring and fall each year and is based on the lenders' assessment of our reserves and future commodity prices. If not extended by any or all lenders, the commitments of such non-extending lenders under the RBL will cease to revolve, all outstanding advances thereunder owing to such non-extending lenders will become repayable in one year from the term date and the margins owing on such outstanding advances will increase by 0.50%. In the event the borrowing base is reduced below amounts outstanding, any excess will become due and payable 60 days subsequently.

Borrowing base redetermination will be required if the Company’s Liability Management Rating (LMR) or equivalent measurement falls below 2.00 in any material jurisdiction where Pipestone Energy operates. The Company’s LMR rating was 9.21 in Alberta on the closing date of the RBL financing.

Advances under the RBL are available by way of Canadian prime rate, and U.S. base rate loans with interest rates between 0.50 percent and 2.50 percent over the bank's prime lending rate, as well as bankers' acceptances and London Inter-bank Offered Rate (LIBOR) loans, which are subject to stamping fees and margins ranging from 1.50 percent to 3.50 percent depending upon our senior debt to Earnings Before Interest, Taxes, Depreciation and Amortization

(EBITDA) ratio calculated at our previous quarter end. Given the start-up nature of Pipestone Energy's operations in 2019, for purposes of calculating EBITDA, the credit agreement allows for annualized EBITDA calculations for Q4 2019, Q1 2020, Q2 2020, and Q3 2020.

As at December 31, 2019, Pipestone's applicable pricing included a 1.00 percent per annum margin on prime loans, a 2.00 percent per annum stamping fee and margin on bankers' acceptances and LIBOR loans along with a 0.45 percent per annum standby fee on the portion of the RBL that is not drawn. Borrowing margins and fees are reviewed annually as part of the bank syndicate's annual renewal.

The credit agreement contains customary borrowing base provisions and negative covenants including, but not limited to, restrictions on our ability to incur indebtedness, grant liens or security interests on assets, sell or otherwise transfer assets, make distributions, make investments or provide financial assistance and our ability to merge and consolidate with other companies or change our line of business, in each case, subject to certain exceptions.

The credit agreement contains customary positive covenants including, but not limited to, delivery of financial and other information to the lenders, maintenance of existence, payment of taxes and other claims, maintenance of properties and insurance, access to books and records by the lenders, compliance with applicable laws and regulations, including environmental laws, and further assurances and provision of additional collateral and guarantees.

The credit agreement provides that, upon the occurrence of certain events of default, our obligations thereunder may be accelerated and the lending commitments terminated. Such events of default include payment defaults to the lenders, covenant defaults, inaccuracies of representations and warranties, bankruptcy and insolvency proceedings, business suspension, material money judgments, cross defaults, change of control and other customary events of default. As is customary, the facility contains material adverse change clauses which would enable the lenders to demand immediate repayment of amounts outstanding if determined to represent an event of default.

The indebtedness under the credit agreement is secured by floating charges and a security interest against our current and future real and personal property. The Company does not currently have any material subsidiaries and, as such, no guarantees have been provided under the credit agreement.

The revolving period of the RBL currently ends on November 30, 2020 with an additional one-year term out period thereafter if the revolving period is not extended. An extension of the revolving period is subject to majority lender consent.

The RBL fully replaced Pipestone Energy's $198.5 million, first lien credit facility (the "Credit Facility") which was comprised of a $10.0 million revolving operating line, a $20.0 million letter of credit facility, and a $168.5 million delayed-draw term loan (the "Term Loan"). The Term Loan was funded in fixed tranches to fund capital expenditures and general corporate expenses. Interest on the operating line and letter of credit facility was payable in cash, while interest on the Term Loan is added to the debt balance.

The debt exchange was accounted for in accordance with IFRS 9. The RBL has substantially different terms from the Credit Facility and thus was accounted for as an extinguishment of debt. The carrying amount of the Credit Facility was de-recognized and the fair value of the RBL was recognized with the difference recorded as a loss during the year ended December 31, 2019.

Standby fees were charged on the undrawn portion of the Term Loan at a rate of 0.50 percent and the Company entered into two separate floating-to-fixed interest rate swaps with the lending institutions.

The initial swap was entered into on March 12, 2018 and resulted in the 2018 funding of $50.0 million ($30.0 million in March 2018 and $20.0 million in July 2018) bearing a fixed annual interest rate of 7.75 percent for the term from March 12, 2018 to February 28, 2019, 7.25 percent from March 1, 2019 to September 2, 2019 and 6.85 percent from September 3, 2019 to March 12, 2020.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

The second swap was entered into just prior to the closing of the Corporate Acquisition and resulted in the 2019 funding of $100.0 million ($10.0 million in January 2019, $20.0 million in March 2019, $32.5 million in June 2019 and $37.5 million in September 2019) bearing a fixed annual interest rate of 9.75 percent for the term from January 4, 2019 to March 31, 2020.

Both swaps survived the replacement of the Credit Facility with the RBL.

The average rate of interest on the bank debt for the year ended December 31, 2019 was 8.3 percent.

11. Lease liabilities

Years ended December 31,	2019
	$
Balance, January 1, 2019 (note 3)	44
Corporate acquisition (note 5)	1,630
Additions	53,082
Interest expense (note 16)	1,239
Lease payments	(2,078)
Balance, end of year	**53,917**
Current liability	3,617
Long-term liability	50,300

Lease terms are negotiated on an individual basis and contain a range of terms and conditions. The discount rates used to determine lease liabilities for office leases, field equipment and compressors added this year was 8.0 percent, 8.0 percent and 12.0 percent, respectively.

The following table details the undiscounted cash flows and contractual maturities of Pipestone Energy's lease liabilities, as at December 31, 2019:

	2019
	$
2020	9,845
2021	9,891
2022	9,410
2023	9,292
2024	9,292
Thereafter	42,995
Total undiscounted future lease payments	90,725
Amounts representing lease interest expense over the term of the lease	(36,808)
Present value of net lease payments	53,917

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

Payments for leases on which practical expedients were applied:

Years ended December 31,	2019
	$
Low-dollar lease payments	6
Short-term lease payments	116

The Company included extension options in the calculation of lease liabilities, where Pipestone Energy has the right to extend the lease term at its discretion and is more than likely to exercise the extension option. The Company does not have any significant termination options and the residual amounts are not material.

12. Decommissioning provisions

The Company's decommissioning provisions result from its ownership interest in liquids and natural gas assets, including well sites, facilities and gathering systems. The total decommissioning provision is estimated based on the Company's net ownership interest, estimated costs to reclaim and abandon its wells, facilities and gathering systems and the estimated timing of the costs to be incurred in future years. The estimated cash flows required to settle the provisions, excluding salvage, are approximately $7.5 million at December 31, 2019 (December 31, 2018 – $2.2 million). This was inflated using a weighted-average rate of 1.4 percent (December 31, 2018 – 2.0 percent) to arrive at undiscounted future cash flows of approximately $10.3 million (December 31, 2018 – $3.6 million) and then discounted using a weighted-average risk-free rate of 1.8 percent at December 31, 2019 (December 31, 2018 – 2.2 percent) to arrive at the present value of the decommissioning provision as disclosed below. The inflation rate was determined using the Fisher equation, which is calculated as the difference between the Government of Canada nominal rate of interest (1.8 percent) and the real rate of interest (0.4 percent) at December 31, 2019, and was treated as a change in estimates from the prior year. The weighted-average risk-free rate is based on Government of Canada benchmark bond rates. These obligations are to be settled based on the estimated economic lives of the underlying assets, which currently extend up to 38 years, with the majority of the costs expected to be incurred between 2045 and 2055 and will be funded from general corporate resources at the time of abandonment.

The following reconciles the decommissioning provisions:

Years ended December 31,	**2019**	2018
	$	$
Balance, beginning of year	**2,085**	907
Additions	**2,309**	1,078
Corporate acquisition (note 5)	**908**	-
Change in discount rate, corporate acquisition [1]	**1,918**	-
Accretion (note 16)	**110**	33
Changes in estimates	**(1,086)**	-
Change in discount rates	**481**	67
Costs incurred	**(3)**	-
Balance, end of year	**6,722**	**2,085**

(1) Revaluation of the liabilities acquired in the Corporate Acquisition (note 5) using the risk-free discount rate. At the date of acquisition, acquired decommissioning provisions are fair-valued using a market discount rate.

13. Share capital

a) Authorized – Unlimited number of common shares with no par value.

b) Issued

	Shares	Amount
	(000s)	**$**
Balance, January 1, 2018[1]	52,782	88,025
Issuance of common shares [1]	22,786	38,000
Balance, December 31, 2018 [1]	**75,568**	**126,025**
Issuance of common shares [1]	28,182	47,000
Issued on Corporate Acquisition (note 5) [1]	85,859	206,061
Issued on exercise of stock options (note 14(a))	19	168
Issued on employee stock purchase plan (note 14(d))	155	215
Balance, December 31, 2019	**189,783**	**379,469**

(1) The number of common shares has been adjusted retrospectively to reflect a 10:1 share consolidation, as well as the 0.5996 exchange ratio, as part of the Corporate Acquisition (note 5).

c) Loss per share

The following sets forth the computation of per-share amounts:

Years ended December 31,	**2019**	2018
Numerator		
Loss attributable to common shares ($)	**(13,985)**	(12,122)
Denominator		
Weighted-average number of shares outstanding for basic and diluted per-share calculation (000s) [1]	**188,401**	54,780
Basic and diluted loss per share attributable to common shares ($/share)	**(0.07)**	(0.22)

(1) The number of common shares has been adjusted retrospectively to reflect a 10:1 share consolidation, as well as the 0.5996 exchange ratio, as part of the Corporate Acquisition (note 5).

For the year ended December 31, 2019, 17.5 million warrants, 1.5 million stock options, 0.6 million performance share units and 0.9 million restricted share units were excluded from the diluted weighted-average share calculation as they were anti-dilutive. Pipestone Energy had no dilutive instruments outstanding in 2018.

d) Warrants

As at December 31, 2019 there are 17,518,809 warrants (175,188,092 prior to the 10:1 share consolidation) outstanding that were continued from the Corporate Acquisition (note 5). Each warrant is exercisable for 1 common share at a price of $3.00 (exercisable for 0.1 common share at a price of $0.30 prior to the 10:1 share consolidation) and expires on May 19, 2021 if not previously exercised.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

14. Share-based compensation

Pipestone Energy's long-term incentive plan (LTIP) allows for the granting of equity incentive units to its directors, officers, employees and consultants of the Company. The Company's current share-based compensation plans consist of stock options, performance share units (PSUs) and restricted share units (RSUs). The Company also implemented an employee share purchase plan (ESPP) which allows employees to voluntarily contribute up to a capped portion of their base salary, which is then matched by the Company, and exchanged for Pipestone Energy common shares.

During the year ended December 31, 2019, Pipestone Energy recognized $0.8 million of share-based compensation expense (year ended December 31, 2018 - $Nil).

The following provides information with respect to outstanding equity compensation units at December 31, 2019:

	Units outstanding	Weighted-average remaining contractual life (years)	Units outstanding – weighted-average exercise price ($)	Units exercisable	Units exercisable – weighted-average exercise price ($)
Stock options [(1)]	1,499,643	3.2	2.99	969,643	3.92
PSUs	648,970	2.3	-	-	-
RSUs	858,981	2.5	-	-	-
Units outstanding	**3,007,594**	**2.8**	**1.49**	**969,643**	**3.92**

(1) Following the Corporate Acquisition (note 5), holders of Blackbird stock options are entitled to Pipestone Energy common shares, after adjusting the quantity of awards outstanding based on the 10:1 share consolidation. The fair value of the awards, all of which vested upon the closing of the transactions, was included in the consideration. Therefore, the exercise prices and quantities of awards shown are post-conversion of every 10 Blackbird options into 1 Pipestone Energy common share.

a) Stock options

Pipestone Energy is authorized to issue stock options exercisable for up to 5,688,690 common shares of the Company under its LTIP. The exercise price of stock options issued pursuant to the plan are equal to the preceding 5-day volume weighted average trading price of Pipestone Energy common shares on the TSXV from their grant date. It is the Company's intention for the stock options it grants to generally vest one-third on each of the first, second and third anniversaries of the grant date and expire five years from grant.

During the year ended December 31, 2019, the Company granted 530,000 stock options (year ended December 31, 2018 – no options) to acquire common shares on a 1:1 basis. The stock options vest one-third on each of the first, second and third anniversaries of their grant date and expire five years from grant. The initial fair value of the stock options granted during the year ended December 31, 2019 was determined using the Black-Scholes option pricing model with the following weighted-average assumptions:

Years ended December 31,	**2019**	2018
Fair value of options granted ($)	**0.57**	-
Risk-free interest rate (%)	**1.48**	-
Expected life (years)	**3.6**	-
Expected forfeiture rate (%)	**5.0**	-
Expected volatility (%)	**59.3**	-
Expected dividend yield (%)	**-**	-

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

The fair value of stock options is recognized as share-based compensation expense over the vesting period with a corresponding increase to contributed surplus. Upon exercise of the stock option, the previously recognized value in contributed surplus and any cash proceeds received will be recorded as an increase to share capital.

The following provides information with respect to stock option transactions:

Years ended December 31,	**2019**		2018	
	Options	**Weighted-average exercise price**	Options	Weighted-average exercise price
	#	**$**	#	$
Outstanding, beginning of year	**-**	**-**	**-**	**-**
Continued from Corporate Acquisition [1]	3,547,793	3.68		
Granted	530,000	1.29	-	-
Exercised[2]	(250,000)	1.80	-	-
Forfeited / expired	(2,328,150)	3.79	-	-
Outstanding, end of year	**1,499,643**	**2.99**	**-**	**-**

1) The Company had 3,547,793 stock options (35,477,945 prior to the 10:1 share consolidation), continued as part of the Corporate Acquisition (note 5). The Company had 2,328,150 stock options (23,281,500 prior to the 10:1 share consolidation), continued as part of the Corporate Acquisition, forfeited / expired, and 250,000 stock options (2,500,000 prior to the 10:1 share consolidation), continued as part of the Corporate Acquisition, exercised, during the year ended December 31, 2019. At December 31, 2019, there are 969,643 stock options (9,696,438 prior to the 10:1 share consolidation) outstanding that are related to the Corporate Acquisition which will continue in accordance with their existing terms.

2) The Company temporarily permitted holders of stock options related to the Corporate Acquisition to exercise their in-the-money stock options on a non-cash basis. These transactions resulted in 18,571 Pipestone Energy common shares being issued which was the equivalent of the implied value of the 250,000 in-the-money stock options based on market prices at the time of exercise.

The following provides information about stock options outstanding at December 31, 2019:

Range of exercise prices ($)	**Number outstanding**	**Weighted-average remaining contractual life (years)**	**Options outstanding – weighted-average exercise price ($)**	**Number exercisable**	**Options exercisable – weighted-average exercise price ($)**
1.09 – 2.99	680,000	3.8	1.40	150,000	1.80
3.00 – 4.99	519,643	3.0	3.31	519,643	3.31
5.00 – 6.50	300,000	2.0	6.03	300,000	6.03
	1,499,643	**3.2**	**2.99**	**969,643**	**3.92**

At December 31, 2019, the Company has 4,189,047 stock options remaining available for issuance from its original reserve.

b) PSUs

Pipestone Energy is authorized to issue PSUs exchangeable for up to 5,688,690 common shares of the Company under its LTIP.

During the year ended December 31, 2019, the Company granted 648,970 PSUs (year ended December 31, 2018 – no PSUs granted). Each PSU entitles the holder to be issued the number of common shares designated in the performance award, multiplied by a payout multiplier ranging from 0 to 2.0x, at a future date (typically three years from the grant date).

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

No cash settlement option exists on the PSUs currently issued and outstanding. The payout multiplier for performance-based awards will be determined by the Board based on an assessment of the Company's achievement of predefined corporate performance measures in respect of the applicable period.

At December 31, 2019, the Company has 4,390,750 PSUs remaining available for issuance from its original reserve.

The initial fair value of the PSUs granted during the year ended December 31, 2019 was determined with reference to the preceding 5-day volume weighted average trading price of Pipestone Energy common shares on the TSXV from their grant date adjusted for the estimated performance multiple required to settle them. During the year ended December 31, 2019, the weighted-average fair value of PSUs granted was $1.41 (year ended December 31, 2018 – no PSUs granted). This fair value is recognized as share-based compensation expense over the vesting period with a corresponding increase to contributed surplus. The amount of the compensation expense is reduced by an estimated forfeiture rate determined at the date of the grant and updated each period. Upon vesting of the awards and settlement in common shares, the previously recognized value in contributed surplus will be recorded as an increase to share capital.

The following provides information with respect to PSUs transactions:

Years ended December 31,	**2019**	2018
	$	$
Balance, beginning of year	**-**	**-**
Granted	648,970	-
Balance, end of year	**648,970**	**-**

c) RSUs

Pipestone Energy is authorized to issue RSUs exchangeable for up to 5,688,690 common shares of the Company under its LTIP.

During the year ended December 31, 2019, the Company granted 858,981 RSUs (year ended December 31, 2018 – no RSUs granted) that are exchangeable for common shares on a 1:1 basis. The RSUs vest one-third on each of the first, second and third anniversaries of their grant date and will be settled through the release of Pipestone Energy common shares. No cash settlement option exists on the RSUs currently issued and outstanding.

At December 31, 2019, the Company has 4,829,709 RSUs remaining available for issuance from its original reserve.

The initial fair value of the RSUs granted during the year ended December 31, 2019 was determined with reference to the preceding 5-day volume weighted average trading price of Pipestone Energy common shares on the TSXV from their grant date. During the year ended December 31, 2019, the weighted-average fair value of RSUs granted was $1.44 (year ended December 31, 2018 – no RSUs granted). This fair value is recognized as share-based compensation expense over the vesting period with a corresponding increase to contributed surplus. The amount of the compensation expense is reduced by an estimated forfeiture rate determined at the date of the grant and updated each period. Upon vesting of the awards and settlement in common shares, the previously recognized value in contributed surplus will be recorded as an increase to share capital.

The following provides information with respect to RSU transactions:

Years ended December 31,	**2019**	2018
	$	$
Balance, beginning of year	**-**	**-**
Granted	858,981	-
Balance, end of year	**858,981**	**-**

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

d) Employee stock purchase plan (ESPP)

Pipestone Energy has an ESPP to provide its employees with an opportunity to purchase common shares of the Company. Employees may direct up to 10 percent of their base salary for the purchase of shares under the ESPP at the 5-day volume-weighted-average trading price of Pipestone Energy common shares on the TSXV with the Company matching such personal contributions 100 percent. Common shares purchased by the employee are available for immediate transacting while the employer matched portion is subject to a 12-month holding period.

Under the terms of the ESPP, common shares may be issued from treasury or acquired by the plan administrator on the open market. During the year ended December 31, 2019, all common shares were issued from treasury. Proceeds collected from employees are recognized directly to share capital. The fair value of employer contributed common shares to the plan are recognized as share-based compensation expense with the offset to share capital in the period of issuance.

Pipestone Energy's share of the contributions in 2019 amounted to $0.1 million (year ended December 31, 2018 – Nil) and is recorded in share-based compensation.

e) Contributed surplus

Years ended December 31,	**2019**	2018
	$	$
Balance, beginning of year	**-**	**-**
Corporate acquisition (note 5)	772	-
Exercise of stock options	(168)	-
Share-based compensation expensed	647	-
Balance, end of year	**1,251**	**-**

15. Sales of liquids and natural gas

Years ended December 31,	**2019**	2018
	$	$
Product type		
Crude oil	**1,257**	-
Condensate	**44,552**	1,628
Other natural gas liquids	**1,802**	-
Total natural gas liquids	**46,354**	1,628
Natural gas	**14,910**	-
Sales of liquids and natural gas	**62,521**	1,628

Pipestone Energy's sales are comprised of liquids and natural gas to various customers. Sales from the transfer of liquids and natural gas volumes to customers are recognized at the time when Pipestone Energy's performance obligations are fully satisfied upon transfer of these volumes to customers.

Included in accounts receivable at December 31, 2019 is $18.0 million (December 31, 2018 - $Nil) of accrued liquids and natural gas sales related to production from periods prior to the reporting date.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

16. Financing expense

Years ended December 31,	**2019**	2018
	$	$
Financing expense		
Letter of credit fees	**1,639**	-
Lease liabilities interest expense (note 11)	**1,239**	-
Interest on bank debt, including interest added to principal (note 10)	**9,432**	141
Bank charges	**62**	5
Cash financing expense	**12,372**	146
Interest on bank debt	**-**	2,693
Accretion on decommissioning provisions (note 12)	**110**	33
Amortization of bank debt issuance costs	**6,178**	602
Non-cash financing expense	**6,288**	3,328
Total financing expense	**18,660**	3,474

17. Income tax

a) Deferred income tax recovery

The following table reconciles income taxes calculated at the Canadian federal-provincial statutory rate with the recorded income tax provision included in profit or loss:

Years ended December 31,	**2019**	2018
	$	$
Loss before income taxes	**(25,113)**	(12,180)
Canadian federal-provincial statutory tax rate	**26.5%**	27.0%
Expected income tax recovery	**(6,655)**	(3,289)
Corporate income tax rate change	**(1,552)**	-
Recognition of previously unrecognized deferred tax asset	**(3,229)**	-
Unrecognized deferred tax asset	**-**	3,229
Share-based compensation	**200**	-
Other	**108**	2
Actual deferred income tax recovery	**(11,128)**	(58)

For the year ended December 31, 2019, the deferred income tax recovery includes $1.5 million attributable to decreases in the Alberta provincial income tax rate for the periods from July 1, 2019 to January 1, 2022, which reduced the provincial rate to 11 percent effective July 1, 2019, and further reduces it by 1 percent on January 1 for each of the years 2020, 2021 and 2022, bringing the provincial and federal combined rate to 8 percent and 23 percent, respectively.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

b) Deferred income taxes

Temporary differences that give rise to deferred income taxes are as follows:

As at December 31,	**2019**	2018
	$	$
Deferred tax assets		
Non-capital losses	**54,280**	15,981
Debt and share issuance costs	**896**	102
Financial derivative instruments	**536**	744
Decommissioning provisions	**1,546**	563
Lease liabilities	**12,401**	-
Deferred tax liabilities		
Deferred financing	**-**	(660)
P&E, E&E and ROU assets	**(77,893)**	(16,730)
Net deferred tax asset (liability)	**(8,234)**	-

For purposes of the above table, deferred income tax liabilities are shown net of offsetting deferred income tax assets where these occur in the same jurisdiction.

Deferred tax assets have not been recognized in respect of the following items:

As at December 31,	**2019**	2018
	$	$
Non-capital losses	**-**	11,959
	-	11,959

Movement in the deferred tax asset or liability during the year ended December 31, 2019:

	Balance, January 1, 2019	Corporate acquisition	Recognized in loss	**Balance, December 31, 2019**
	$	$	$	$
P&E, E&E and ROU assets	(16,730)	(33,622)	(27,541)	**(77,893)**
Deferred financing	(660)	-	660	**-**
Financial derivative instruments	744	-	(208)	**536**
Decommissioning provisions	563	245	738	**1,546**
Lease liabilities	-	-	12,401	**12,401**
Non-capital losses	19,210	13,034	22,036	**54,280**
Unrecognized deferred tax asset	(3,229)	-	3,229	**-**
Debt and share issuance costs	102	981	(187)	**896**
Deferred tax asset (liability)	-	(19,362)	11,128	**(8,234)**

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

Movement in the deferred tax asset or liability during the year ended December 31, 2018:

	Balance, January 1, 2018	Recognized in loss	**Balance, December 31, 2018**
	$	$	$
P&E and E&E assets	(5,186)	(11,544)	**(16,730)**
Deferred financing	-	(660)	**(660)**
Financial derivative instruments	-	744	**744**
Decommissioning provisions	245	318	**563**
Non-capital losses	4,883	14,327	**19,210**
Unrecognized deferred tax asset	-	(3,229)	**(3,229)**
Debt and share issuance costs	-	102	**102**
Deferred tax asset (liability)	(58)	58	**-**

c) Tax pools

Estimated tax pools are as follows:

As at December 31,	**2019**	2018
	$	$
Canadian oil and gas property expense	**31,667**	17,485
Canadian development expense	**118,410**	83,121
Canadian exploration expense	**46,165**	825
Non-capital losses	**235,957**	71,143
Undepreciated capital cost (UCC) pools	**75,398**	26,683
Debt and share issuance costs	**3,897**	1,275
	511,494	200,532

The above tax pools include non-capital losses that expire commencing in the year 2024, with all but $1.8 million expiring after 2030.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

18. Supplemental cash flow information

Changes in non-cash working capital are comprised of:

Years ended December 31,	**2019**	2018
	$	$
Cash flows relating to:		
Accounts receivable	**(19,766)**	62
Prepaid expenses and deposits	**(1,333)**	(713)
Accounts payable and accrued liabilities	**15,107**	33,155
Non-cash working capital acquired (note 5)	**(12,582)**	-
Changes in non-cash working capital	**(18,574)**	32,504
Changes in non-cash working capital relating to:		
Operating activities	**7,777**	4,292
Investing activities	**(26,351)**	28,212
	(18,574)	32,504

During the year ended December 31, 2019, the Company paid $nil in income taxes (December 31, 2018 - $nil). See note 16 for details of interest paid during the years ended December 31, 2019 and 2018.

19. Related-party transactions

During the year ended December 31, 2019, Pipestone Energy incurred $3.6 million of general and administrative expenses from CNOR LP. At December 31, 2019, $3.0 million (December 31, 2018 – $4.8 million) was included in accounts payable and accrued liabilities and was due under normal credit terms. All related-party transactions are recorded at the exchange amount. At December 31, 2019, CNOR LP held approximately 55 percent of Pipestone Energy's issued and outstanding common shares.

20. Commitments and contingencies

As part of its normal operations, Pipestone Energy has committed to paying certain amounts over the next five years and thereafter as follows:

	2020	**2021**	**2022**	**2023**	**2024**	**Thereafter**
	$	$	$	$	$	$
Gathering commitments	9,759	10,255	10,334	10,334	10,340	49,658
Processing commitments	14,513	22,113	24,112	24,112	24,178	116,598
Transportation commitments	16,925	16,355	16,965	16,965	17,011	99,375
Total payments	**41,197**	**48,723**	**51,411**	**51,411**	**51,529**	**265,631**

Pipestone Energy's commitments related to its accounts payable and accrued liabilities and bank debt are disclosed in note 4(d), risk management program in note 4(e) and lease liabilities in note 11.

Lawsuits may be filed against the Company from time to time for incidents which arise in the ordinary course of business. In the opinion of management, the outcome of any of the lawsuits, currently pending, are not determinable and in total not material to the Company's operations. Should any loss result from the resolution of these claims, such loss will be charged to earnings in the year of resolution.

(tabular amounts in thousands of Canadian dollars unless otherwise indicated)

21. Subsequent events

Commodity financial derivative instruments

Subsequent to December 31, 2019, the Company unwound the following commodity hedges for total proceeds received of $3.9 million to crystalize the value of a portion of its contracts in place:

	WTI swaps	
Term	**bbls/d**	**C$/bbl**
Jul. – Dec. '20	250	77.25
Jul. – Nov. '20	1,250	76.74
Jan. – Nov. '20	500	78.55

	WTI collar	
Term	**bbls/d**	**C$/bbl**
Jan. – May '20	250	73.00 - 81.20

Subsequent to December 31, 2019, the Company entered the following commodity hedge:

	WTI swaps	
Term	**bbls/d**	**C$/bbl**
Apr. – Aug. '20	250	73.10