



COURT FILE NUMBER

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COURT

COURT OF QUEEN'S BENCH OF ALBERTA

JUDICIAL CENTRE

CALGARY

APPLICANTS

IN THE MATTER OF THE COMPANIES' CREDITORS  
ARRANGEMENT ACT, R.S.C. 1985, c. C-36, as amended

IN THE MATTER OF THE BUSINESS CORPORATIONS ACT,  
R.S.A. 2000, c. B-9, as amended

AND IN THE MATTER OF THE PLAN OF COMPROMISE OR  
ARRANGEMENT OF ELCANO EXPLORATION INC., ELCANO  
EXPLORATION LTD. and ELCANO EXPLORATION PARTNERSHIP

DOCUMENT

**PRE-FILING REPORT OF HARDIE & KELLY INC.,  
IN ITS CAPACITY AS PROPOSED MONITOR OF ELCANO  
EXPLORATION INC., ELCANO EXPLORATION LTD. and  
ELCANO EXPLORATION PARTNERSHIP**

**FEBRUARY 20, 2019**

ADDRESS FOR SERVICE  
AND CONTACT  
INFORMATION OF PARTY  
FILING THIS DOCUMENT

**PROPOSED MONITOR**  
Hardie & Kelly Inc.  
110, 5800 - 2<sup>nd</sup> Street SW  
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**PRE-FILING REPORT OF THE PROPOSED MONITOR  
HARDIE & KELLY INC.  
FEBRUARY 20, 2019**

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## INTRODUCTION

1. Hardie & Kelly Inc. (“**H&K**” or the “**Proposed Monitor**”) has been advised that Elcano Exploration Inc. (“**EEI**”) and Elcano Exploration Ltd. (“**EEL**”) (collectively referred to as the “**Applicants**”) will be making an application to the Court of Queen’s Bench of Alberta (the “**Court**”) for an order (the “**Initial Order**”) granting an initial stay of proceedings against the Applicants until March 26, 2019 pursuant to the *Companies Creditors Arrangement Act*, R.S.C. 1985 c. C-36, as amended (the “**CCAA**”). The Applicants propose that H&K be appointed as Monitor of the CCAA proceedings (the “**Proceedings**”).
2. Elcano Exploration Partnership (“**EEP**”) is a partnership, with respect to which EEI and EEL are the partners, the three entities of which are collectively referred to as the “**Elcano Group**”. While EEP is not an applicant to the Proceedings, the Applicants will be requesting that this Honourable Court also grant a stay of proceedings with respect to EEP.

## PURPOSE

3. The purpose of this limited scope report (the “**Pre-Filing Report**”) is to provide information to this Honourable Court with respect to:
  - a. H&K’s qualification to act as Monitor;
  - b. A brief overview of the Applicants and their businesses;
  - c. The Proposed Monitor’s understanding of the facts underlying the basis for the CCAA application;
  - d. An overview of the Applicants’ initial cash flow forecast prepared in accordance with section 10(2) of the CCAA; and
  - e. Details surrounding the Applicants’ request of the Court for:
    - i. The granting of a stay of proceedings;
    - ii. The establishment of a sale and investor solicitation process (the “**SISP**”) and the retention of GMP FirstEnergy (“**GMP**”) as the Elcano Group’s sales advisor to administer the SISP;

- iii. The establishment of certain Court ordered charges; and
  - iv. The extension of a stay of proceedings to EEP.
4. This Pre-Filing Report is not intended to be a comprehensive review of the business and affairs of the Applicants. Should H&K be appointed as the Monitor, it is the intention of H&K to file a comprehensive report in advance of the next Court application made in the Proceedings.

#### **TERMS OF REFERENCE AND DISCLAIMER**

5. In preparing this Pre-Filing Report, the Proposed Monitor has been provided with, and has relied upon unaudited financial information, certain books and records of the Applicants and EEP and discussions with the Applicants' management ("**Management**") (collectively the "**Information**"). Except as described in this Pre-Filing Report, the Proposed Monitor has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such Information in a manner that would wholly or partially comply with Generally Accepted Assurance Standards ("**GAAS**") pursuant to the Chartered Professional Accountants Canada Handbook and, accordingly, the Proposed Monitor expresses no opinion or other form of assurance contemplated under GAAS in respect of such information.
6. Some of the Information referred to in this Pre-Filing Report consists of forecasts and projections. An examination or review of any financial forecast and projections, as outlined in the Chartered Professional Accountants Canada Handbook, has not been performed.
7. Unless otherwise stated, all monetary amounts noted herein are expressed in Canadian dollars.

## HARDIE & KELLY INC.'S QUALIFICATIONS TO ACT AS MONITOR

8. H&K is a trustee within the meaning of section 2(1) of the *Bankruptcy and Insolvency Act* and is not subject to any of the restrictions on who may be appointed as monitor set out in Section 11.7(2) of the CCAA. H&K has provided its consent to act as Monitor in the Proceedings, a copy of which is attached as Exhibit "17" to the Affidavit of Mr. Scott Pincock sworn on February 20, 2019 (the "**Initial Pincock Affidavit**") and filed in the Proceedings.

## BUSINESS OVERVIEW

9. EEI is a private Alberta corporation having approximately 150 shareholders. EEI is an operating oil company with its key properties located in Manitoba and some additional interests in Alberta and Saskatchewan. EEI holds all of the Elcano Group's undeveloped assets in Manitoba. EEI is also the managing partner of EEP.
10. EEL is a wholly owned subsidiary of EEI. EEL holds the Elcano's Group's undeveloped assets in Saskatchewan.
11. EEP holds all of the Elcano Group's producing assets, facilities, well licences and facility licences.
12. The Elcano Group's operations focus principally on light oil in the Williston Basin in Southwestern Manitoba. The Elcano Group has core properties in three areas in Manitoba: North Hargrave, Miniota, and Two Creeks. This core land base accounts for approximately 95% of EEI's production and holds the majority of EEI's development growth opportunities.
13. Average daily net sales volumes from all of the Elcano Group's properties for the third quarter of 2018 were reported at approximately 591 barrels per day of high netback light oil at an average realized equivalent selling price of \$77.30 per barrel.
14. In addition to its producing assets, Management advises that the Elcano Group has identified 77 drilling locations and 7 low-risk, high return optimization opportunities in the Lodgepole, Amaranth and Bakken plays.

15. The Elcano Group is also the 100% owner and operator of significant transportation and processing infrastructure in Manitoba, comprised of a gathering system of approximately 43 km of operated flowlines and 26,000 bbl/d water disposal capacity affording the Elcano Group with a low cost operating structure as well as the opportunity to generate third party processing revenue.

#### **H&K'S UNDERSTANDING OF THE BASIS OF THE APPLICATION**

16. As noted in the Initial Pincock Affidavit, EEI's principal secured lender is National Bank of Canada ("NBC). EEL and EEP have provided unlimited guarantees of EEI's obligations to NBC.
17. There are three credit facilities (the "**Facilities**") in place with NBC as follows:
  - a. Credit Facility "A" - a demand revolving reducing credit facility with a current balance outstanding nearing \$6.0 Million. The maximum amount currently available under the facility is \$6.5 Million. Pursuant to an agreement made with NBC in October 2017, EEI was required to reduce the borrowing base in respect of this facility from \$11.75 Million at that time by \$250,000 on October 31, 2017 and by monthly increments of \$500,000 thereafter;
  - b. Credit Facility "B" – a MasterCard Facility for up to \$50,000 with approximately \$9,000 outstanding; and
  - c. Credit Facility "C" – a risk management facility to be used in respect of financial instruments. Management advises the amount currently outstanding under Credit Facility C is estimated as the mark-to-market value of the outstanding derivative contracts of \$478,080 as at February 14, 2019

18. Several factors over the last 18 months have resulted in the Applicants now being in a position of constrained working capital, including the recent volatility of WTI oil prices, the effect of a mandatory hedging program, the softening of the Canadian dollar, the deteriorating differential price for Canadian-produced crude oil, temporary operational challenges and required monthly reductions to Credit Facility “A”.
19. As a result of the above, EEI was ultimately unable to make the required reduction to Credit Facility “A” in September 2018
20. In October 2018, the Applicants and NBC engaged in discussions regarding the Applicants' financial situation and the Facilities.
21. On November 14, 2018, NBC served the Elcano Group with a demand for payment of all indebtedness owed to NBC and Notices of Intention to Enforce Security pursuant to subsection 244(1) of the *Bankruptcy and Insolvency Act*.
22. Since that time, the Elcano Group has entered into forbearance arrangements with NBC, the terms of which included executing a Consent Receivership Order and the retention of Meta Capital Advisors Corporation (“**Meta**”) as its financial advisor to attempt to locate capital providers and secure subordinated debt.
23. The Elcano Group ultimately received several offers (“**LOIs**”) including one from Tallinn Capital Energy Corp. (“**Tallinn**”) proposing a debt transaction, one proposing a share purchase and three proposing an asset purchase.
24. At this time, Management continues to pursue a transaction with Tallinn, but it has also maintained dialogue with other parties who submitted LOIs in the event the contemplated transaction is ultimately not consummated.

25. Management's position is that the Elcano Group's assets are of sufficient value to satisfy all of its obligations to creditors and that there are many parties interested in pursuing a transaction but that a compressed timeline associated with the marketing process initiated by Meta and various agreed upon deadlines associated with forbearance arrangements made with NBC have impeded Management's ability to consummate a transaction in a timely and commercially reasonable manner.
26. Consequently, the Elcano Group is seeking a stay of proceedings under the CCAA so that it can conduct an orderly SISF with a view to allowing for the repayment of NBC and the maximization of asset value, for the benefit of all stakeholders.
27. Management believes that the proposed CCAA SISF would achieve a more favourable result than a sale of the assets by way of a receivership proceeding while also potentially affording greater flexibility to the Applicants, including the ability to preserve and enhance asset value by entering into a transaction(s) other than a sale of all the Elcano Group's assets.

### **CASH FLOW FORECAST**

28. In accordance with section 10(2) of the CCAA, Management has prepared a cash flow forecast (the "**Initial Forecast**") and accompanying notes and assumptions for the period February 25 - May 26, 2019 (the "**Initial Forecast Period**") a copy of which is appended as Exhibit "19" to the Initial Pincock Affidavit. The Initial Forecast has been prepared by Management for the purpose described in the notes attached, using the probable and hypothetical assumptions set out in the attached notes.
29. The Initial Forecast, the accompanying notes and assumptions, and a letter containing the prescribed representations of the Applicants regarding the preparation of the Initial Forecast are collectively attached as Appendix "A" to this Pre-Filing Report. A summary of the Initial Forecast, together with a brief description of the material components is provided below.



	<b>February 25 - May 26, 2019</b>
<b>Receipts</b>	
Production revenues	3,635,440
	<b>3,635,440</b>
<b>Disbursements</b>	
Royalties	(634,191)
Transportation	(110,500)
OPEX	(399,500)
Power	(195,000)
Optimization operations	(839,500)
General and administration	(353,940)
Insurance	(40,000)
Interest	(100,500)
Hedging losses	(311,453)
Financial advisory	(80,000)
Restructuring	(287,500)
	<b>(3,352,084)</b>
Net cash flow	<b>283,356</b>
Cash - beginning	191,000
Cash - closing	<b>474,356</b>

30. In our capacity as the Proposed Monitor of the Elcano Group, we have reviewed the reasonableness of the Initial Forecast in accordance with section 23(1)(b) of the CCAA and can offer the following comments:
- a. There is no requirement for use of the Facilities with NBC nor is there interim financing contemplated as the Applicants' ability to fund its operations though the Initial Forecast Period is dependent on approximately \$191,000 currently maintained in its lawyers trust account and operational cash flow.
  - b. Interest payments are contemplated to continue to be made to NBC during the Initial Forecast Period.

- c. Based on the Initial Forecast and accompanying assumptions, the Proposed Monitor considers that the Applicants' liquidity appears sufficient for the Initial Forecast Period barring any unforeseen circumstances.
  
- 31. Our review consisted of inquiries, analytical procedures and discussions related to information supplied to us by Management. Since hypothetical assumptions need not be supported, our procedures with respect to them were limited to evaluating whether they were consistent with the purpose of the Initial Forecast. We have also reviewed the support provided by Management for the probable assumptions and the preparation and presentation of the Initial Forecast.
  
- 32. Based on our review, nothing has come to our attention that causes us to believe that, in all material respects:
  - a. The hypothetical assumptions are not consistent with the purpose of the Initial Forecast;
  - b. As at the date of this Pre-Filing Report, the probable assumptions developed by Management are not suitably supported and consistent with the plans of the Elcano Group or do not provide a reasonable basis for the Initial Forecast, given the hypothetical assumptions; or
  - c. The Initial Forecast does not reflect the probable and hypothetical assumptions.
  
- 33. Since the Initial Forecast is based on assumptions regarding future events, actual results will vary from the information presented, even if the hypothetical assumptions occur, and such variations may be material. Accordingly, we express no assurance or representations as to whether the Initial Forecast will be met. We express no opinion or other form of assurance with respect to the accuracy of any financial information presented in this Pre-Filing Report. The Initial Forecast has been prepared solely for the purpose described in the notes thereto and readers are cautioned that it might not be appropriate for other uses.

**SALE AND INVESTMENT SOLICITATION PROCESS**

34. The Elcano Group has now retained the services of GMP, an independent global energy investment bank, as its sales advisor (the “**SISP Advisor**”) to administer the SISP. GMP is well respected in the market place and already has good knowledge of the Elcano Group’s assets from previous involvement with Elcano.
35. The Proposed Monitor has reviewed the engagement letter with GMP attached as Exhibit “18” to the Initial Pincock Affidavit and believes that the terms of the engagement are commercially reasonable and generally similar to other matters in which H&K has been involved.
36. The proposed SISP timelines can be summarized as follows:

March 8, 2019	Press Release, Publication of SISP Notice, distribution of Teaser, availability of Virtual Data Room
March 8, 2019 (no later than)	Distribution of Confidential Information Memorandum to Phase 1 Qualified Bidders (as defined in the SISP)
April 26, 2019	Phase 1 bid deadline for non-binding LOIs
May 17, 2019	Phase 2 bid deadline for signed purchase and sale agreements
June 3, 2019	Confirmatory title and environmental due diligence
June 3, 2019	Sign purchase and sale agreement(s)
June 12, 2019	Obtain CCAA sale approval and vesting order(s)
June 14, 2019	Close transaction(s)

37. The Proposed Monitor concurs with the procedures and timelines proposed by the Company as they are not inconsistent with matters in which H&K has previously been involved. GMP has also advised that it believes the timelines are reasonable.

38. As set out earlier in this Pre-Filing Report, while EEP is not an applicant to the Proceedings, the Applicants will be requesting that this Honourable Court also grant a stay of proceedings with respect to EEP.

#### ADMINISTRATION CHARGE

39. The proposed Initial Order provides for a first charge on the assets, property and undertaking of the Applicants in favour of the Monitor, counsel to the Monitor and counsel to the Company as security for the professional fees and disbursements incurred in respect of the Proceedings in the amount of \$100,000 (the “**Administration Charge**”).
40. The Proposed Monitor believes that it is appropriate that the proposed beneficiaries of the Administration Charge be afforded the benefit of such a charge as they will be undertaking key roles in the Applicants’ efforts towards completing a successful restructuring.
41. The Proposed Monitor believes that the quantum of the Administration Charge is reasonable and appropriate in the circumstances and is not unreasonable in comparison to similar Court approved charges in comparable proceedings.

#### DIRECTORS’ CHARGE

42. The Proposed Initial Order provides for a charge a charge on the assets, property ad undertaking of the Applicants in favour of the Applicants’ Directors and Officers (the “**Directors’ Charge**”) in the amount of \$50,000 ranking behind the Administration Charge.

43. Management asserts that a successful restructuring will only be possible with the continued participation of its directors and officers, as these individuals have specialized expertise and relationships with the Applicants' stakeholders. In addition, they also have significant knowledge regarding the Elcano Group's business and operations which cannot be easily replicated or replaced.
44. The quantum of the Directors' Charge was calculated to provide sufficient coverage for employee wages and source deduction over the course of approximately one pay period.
45. The Proposed Monitor agrees that the directors and officers will add value to the restructuring process and is of the view that the creation of the proposed Directors' Charge is reasonable and appropriate in the circumstances.

**STAY OF PROCEEDINGS SOUGHT BY EEP**

46. As set out earlier in this Pre-Filing Report, while EEP is not an applicant to the Proceedings, the Applicants will be requesting that this Honourable Court also grant a stay of proceedings with respect to EEP.
47. In light of the inter-relationship of the members of the Elcano Group, the Proposed Monitor supports the extension of a stay of proceedings to EEP.

All of which is respectfully submitted this 20<sup>th</sup> day of February, 2019.

Hardie & Kelly Inc.,  
in its capacity as the Proposed Monitor of the Elcano Group  
and not in its personal or corporate capacity



Per: Marc Kelly  
Senior Vice President

# APPENDIX "A"

The Elcano Group  
 Cash Flow Forecast  
 For the 13 week period February 25 to May 26, 2019  
 (Unaudited - prepared by management)

	Week of 25-Feb-19	Week of 4-Mar-19	Week of 11-Mar-19	Week of 18-Mar-19	Week of 25-Mar-19	Week of 1-Apr-19	Week of 8-Apr-19	Week of 15-Apr-19	Week of 22-Apr-19	Week of 29-Apr-19	Week of 6-May-19	Week of 13-May-19	Week of 20-May-19	Total
<b>Receipts</b>	954,691	-	-	-	878,569	-	-	-	924,092	-	-	-	876,088	3,635,440
<b>Production revenues</b>	954,691	-	-	-	878,569	-	-	-	924,092	-	-	-	876,088	3,635,440
<b>Disbursements</b>														
Royalties	-	-	218,279	-	-	-	-	202,071	-	-	-	212,541	-	634,191
Transcription	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	8,500	110,500
OPEX	60,000	60,000	10,500	-	-	120,000	16,500	-	110,000	110,000	16,500	-	-	399,500
Power	20,000	20,000	100,000	45,000	-	20,000	-	-	45,000	20,000	-	-	-	194,000
Optimization operations	15,000	-	-	50,000	225,000	48,500	50,000	-	100,000	25,000	-	45,000	-	539,500
General and administrative	59,880	5,000	48,000	5,000	59,980	-	5,000	48,000	5,000	59,980	5,000	48,000	-	353,840
Insurance	33,500	-	-	-	33,500	-	-	-	33,500	-	-	-	-	100,500
Bank interest	62,120	-	-	-	73,328	-	-	-	84,651	-	-	-	91,446	311,453
Hedging losses	20,000	-	-	-	20,000	-	-	-	20,000	-	-	-	20,000	80,000
Financial Advisory	20,000	25,000	25,000	25,000	10,500	12,500	12,500	12,500	12,500	25,000	25,000	25,000	25,000	287,500
Restitutions	309,108	118,500	417,579	133,500	432,808	270,500	92,500	271,071	309,051	288,468	95,000	294,041	419,948	3,552,054
Net cash flow for period	645,305	(118,500)	(417,579)	(133,500)	445,761	(210,500)	(92,500)	(271,071)	615,041	(288,468)	(59,000)	(294,041)	458,142	281,356
Cash/Operating line - beginning	191,000	838,583	718,083	300,504	187,004	612,765	402,265	309,765	38,604	653,715	365,715	310,255	15,214	191,000
Cash/Operating line - closing	836,305	718,083	300,504	187,004	612,765	402,265	309,765	38,604	653,715	365,715	310,255	15,214	474,358	474,358

Elcano Group



Fer Scott Pircock  
 VP Finance and CFO

February 20, 2019  
 CALGARY, ALBERTA

4.55/IMPTIONS AND NOTES  
 - Please refer to the attached.

## Elcano Group

### Note to the Cash Flow Forecast

- 1) **Production revenues** - relate to net proceeds from the sale of oil and gas revenues. Funds are forecast to be received in the month following production. Production forecast is based on recent production levels adjusted for anticipated production decline. The forecast sales price is based on current strip pricing in USD West Texas Intermediate crude ("WTI") adding foreign exchange ("FX") to Canadian Dollars ("CAD") and differentials index to Cromer Light Sour Blend ("LSB") less historical quality discount. Changes in WTI and LSB index will have an impact on Elcano's realized prices and subsequently on revenues collected.
  - 2) **Royalties** - include crown/freehold in Manitoba and are assumed to be paid by the 15<sup>th</sup> of the month following the month production revenues are received. Royalties are estimated based on historical results of being approximately 23% production revenues.
  - 3) **OPEX** – based on historical expenses and assumed production levels including but not limited to such expenditures as lease rentals, utilities, maintenance, repairs, contract operators and property taxes. Payments are assumed to be made in the month goods or services are provided.
  - 4) **Optimization** – Elcano is scheduled to complete the phase one optimization program which includes line looping and the deepening of an existing disposal well. This will result in increases in production May 1, 2019 from three existing wells that are currently shut in due to facility constraints. The optimization is booked as proven developed non-producing reserves in the Sproule December 31, 2018 reserve report.
  - 5) **Transportation** – represents charges for clean oil transportation from Elcano facilities to truck terminal sales points. Invoiced weekly.
  - 6) **General and administrative** – includes but is not limited to such expenses as payroll and benefits for 5 full time and 2 part - time office employees as well as 2 field employees. Includes rent, technology and systems subscriptions and miscellaneous office related expenses.
  - 7) **Interest** – represent payment of monthly interest charged by NBC on the existing credit facility.
  - 8) **Hedging losses** – represents anticipated cash losses from WTI USD swap hedges for Nov, Dec 2018 and 2019 hedges calculated on (January – June 2019 @ 200 bbl/d @ \$44.01 USD WTI). Funds are forecast to be paid in the month following production and settled on the same day as revenues are received. Elcano has an average of 50% of net after royalty production hedged January – April 2019 which corresponds to the revenues. As WTI prices increase so will Elcano losses but will be more than offset by increased revenues on a 2:1 basis.
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9) **Restructuring** – includes the fees and expenses of the company's legal counsel and those of the Monitor and its legal counsel.

10) **Financial Advisors** – monthly work fees only include the SISP advisor.

11) **Cash/Operating line** – At the request of the Lender, Elcano has set up banking with a competitor and will seed the accounts with cash that has been held in trust with the Company's counsel.

If agreed to between the Lender and Elcano, the credit facility balance + valid cheques outstanding is not to exceed \$6.5 million and that the Elcano bank accounts will continue to be operational. Actively using the operating line for deposits would reduce overall interest expense. This can only be accomplished with the support of the lender working cooperatively.

**Critical Suppliers**

Excluded in the CF estimates are costs relating to repairs, well servicing or workovers that would be required for weather related damage to the wells / facility, downhole failure in a wellbore requiring repair, electrical failures. In these instances, the critical suppliers would be paid on COD basis as they have outstanding accounts payable balances that would restrict access to credit.

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# ELCANO EXPLORATION INC.

1600, 521 3RD AVENUE S.W. CALGARY, ALBERTA T2P 3T3 TEL: (403) 460-4188 FAX: (403) 460-4965

Hardie & Kelly Inc.  
110, 5800 – 2<sup>nd</sup> Street SW  
Calgary, AB T2H 0H2

Attention: Mr. Marc Kelly

February 20, 2018

Dear: Mr. Kelly

## **Re: Proceedings under the Companies' Creditors Arrangements Act ("CCAA")**

In connection with the application by the Elcano Group for the commencement of proceedings under the CCAA, the management of the Elcano Group ("Management") has prepared the attached Cash Flow Forecast (the "Forecast") and underlying assumptions upon which the Forecast is based.

Management confirms that:

- The Forecast and underlying assumptions are the responsibility of the Elcano Group;
- All material information relevant to the Forecast and the underlying assumptions have been made available to Hardie & Kelly Inc. in its capacity as the proposed Monitor; and
- Management has taken all actions that it considers necessary to ensure that:
  - The individual assumptions underlying the Forecast are appropriate in the circumstances;
  - That the underlying assumptions, taken as a whole, are appropriate in the circumstances; and
  - All relevant assumptions have been properly presented in the notes to the Forecast.

Management understands and agrees that the determination of what constitutes a material adverse change from the Forecast, or with the financial circumstances of the Elcano Group, is ultimately at the discretion of the Monitor notwithstanding that Management may disagree with such determination.

Yours very truly,

The Elcano Group