

COURT FILE NUMBER 1901-02578

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 **FIRST REPORT OF HARDIE & KELLY INC.,  
IN ITS CAPACITY AS MONITOR OF ELCANO  
EXPLORATION INC., ELCANO EXPLORATION LTD. and  
ELCANO ENERGY PARTNERSHIP**

**MARCH 18, 2019**

ADDRESS FOR SERVICE AND CONTACT  
INFORMATION OF PARTY  
FILING THIS DOCUMENT **MONITOR**  
Hardie & Kelly Inc.  
110, 5800 – 2<sup>nd</sup> Street SW  
Calgary, AB T2H 0H2

Attention: Marc Kelly  
Telephone: 403-536-8510  
Email: mkelly@insolvency.net  
Fax: 403-640-0591

**MONITOR'S COUNSEL**  
Borden Ladner Gervais LLP  
Centennial Place, East Tower  
1900, 520 – 3<sup>rd</sup> Avenue SW  
Calgary, AB T2P 0R3

Attention: Josef G.A. Kruger / Jessica L. Cameron  
Telephone: 403-232-9563 / 403-323-9715  
Email: jkruger@blg.com / jcameron@blg.com  
Fax: 403-266-1395

**FIRST REPORT OF THE MONITOR  
HARDIE & KELLY INC.  
MARCH 18, 2019**

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## INTRODUCTION

1. On February 25, 2019, Elcano Exploration Inc. (“**EEl**”) and Elcano Exploration Ltd. (“**EEL**”) (collectively referred to as the “**Applicants**”) made an application to the Court of Queen’s Bench of Alberta (the “**Court**”) for an 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**”).
2. On February 26, 2019 (the “**Filing Date**”), a *CCAA Initial Order and SISP Approval Order* (the “**Initial Order**”) was granted by the Honourable Madam Justice K.M. Horner of the Court providing certain relief to EEI and EEL, as well as to the Elcano Energy Partnership (collectively referred to as the “**Elcano Group**”), including, but not limited to, the imposition of an initial *Stay of Proceedings* (the “**Stay**”) against the Elcano Group and its assets through to March 28, 2019.
3. The Court appointed Hardie & Kelly Inc. (“**H&K**”) as monitor (the “**Monitor**”) of the Elcano Group’s within CCAA proceedings (the “**CCAA Proceedings**”).
4. On February 20, 2019, H&K filed a report (the “**Pre-Filing Report**”) with the Court in contemplation of the application held on February 25, 2019.
5. The purpose of this report (the “**First Report**”) is to provide updated information to this Honourable Court with respect to:
  - a. The notice issued by the Monitor to the Elcano Group’s creditors informing them of the CCAA Proceedings;
  - b. An operational update since the Filing Date;
  - c. The Elcano Group’s financial performance since the Filing Date;
  - d. The Elcano Group’s cash flow forecast for the period March 18 to June 30, 2019;

- e. The Elcano Group's restructuring activities since the Filing Date;
- f. The Elcano Group's request to pay certain pre-filing obligations and the Monitor's recommendations with respect thereto;
- g. The Elcano Group's request for the establishment of a claims process and the Monitor's recommendation with respect thereto; and
- h. The Elcano Group's request for an extension of the Stay through to June 14, 2019 and the Monitor's recommendation thereto.

### **TERMS OF REFERENCE**

- 6. In preparing this First Report, the Monitor has been provided with, and has relied upon unaudited financial information, certain books and records of the Elcano Group and discussions with management ("**Management**") (collectively the "**Information**"). Except as described in this First Report, the 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 Monitor expresses no opinion or other form of assurance contemplated under GAAS in respect of such information.
- 7. Some of the Information referred to in this First 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.
- 8. All monetary amounts noted herein are expressed in Canadian dollars.

## NOTICE TO CREDITORS

9. The Monitor issued notice of the CCAA Proceedings (the “**Creditor Notice**”) to all known creditors as represented by the Elcano Group. Creditors were directed to the Monitor’s website (the “**Website**”) to obtain copies of the Initial Order and a listing of the known creditors as represented by Management. The Creditor Notice encourages creditors to refer back to the Website regularly for updates as to the status of the CCAA Proceedings. A copy of the Creditor Notice is attached as Appendix “A”.
10. Pursuant to the terms of the Initial Order and the CCAA, the Monitor published a notice of the CCAA Proceedings (the “**Newspaper Notice**”) in the *Winnipeg Free Press* and *Globe & Mail* (National Edition) on March 5, 2019 and March 7, 2019 respectively. A copy of the form of the Newspaper Notice is attached as Appendix “B”.
11. Pursuant to the terms of the CCAA, the Monitor filed *Forms 1 and 2* containing certain prescribed information regarding the CCAA Proceedings with the Office of the Superintendent of Bankruptcy.

## OPERATIONAL UPDATE

12. Following the granting of the Initial Order, there have been no material adverse changes in the Elcano Group’s operations. Since the Filing Date, the Elcano Group has reported average production levels of approximately 514 bbls/day.
13. With the exception of three contract operators as discussed in further detail below, Management, with the assistance of the Monitor, has been able to communicate with suppliers and make mutually satisfactory arrangements to ensure the uninterrupted supply of goods and services to the Elcano Group. The Monitor is not aware of any negative feedback from any creditors.

14. The Affidavit of Mr. Scott Pincock sworn on February 20, 2019 (the “**Initial Pincock Affidavit**”) filed in these CCAA Proceedings referenced an optimization program (the “**Program**”) the Elcano Group intended to execute with a view to increasing production by an estimated 125 bbls/day. The related expenditures for the Program were provided for in the initial cash flow forecast (the “**Initial Forecast**”) for the period February 25 to May 26, 2019 (the “**Initial Forecast Period**”) which was included as Exhibit “19” of the Initial Pincock Affidavit.
15. Since the Filing Date, Management reports that positive initial progress has been made in respect of the Program, including: having entered into the necessary surface rights agreements with affected landowners, applying for and receiving all three flowline licenses from the Manitoba Petroleum Branch, removing snow from the flowline rights-of-way, identifying existing flowlines and other underground barriers, and securing two flowline boring units with crews. Construction commenced on March 15, 2019.
16. Management believes that the Program will be successfully completed in its entirety by May 1, 2019 as anticipated in the Initial Pincock Affidavit.
17. Since the Filing Date, Management has had regular meetings and communications with the Monitor to advise the Monitor of the ongoing operational status, daily production levels and the progress of the Program.

#### **FINANCIAL PERFORMANCE**

18. A variance analysis of the Company’s actual receipts and disbursements since the Filing Date through to March 17, 2019 versus the corresponding period in the Initial Forecast is set out in the following table:

	February 26 - March 17, 2019			
	Actual	Forecast	Variance	Notes
<b>Receipts</b>				
Production revenues	1,016,489	954,691	61,798	a)
Net GST	16,052	-	16,052	b)
Accounts receivable	12,163	-	12,163	c)
	<u>1,044,704</u>	<u>954,691</u>	<u>90,013</u>	
<b>Disbursements</b>				
Royalties	-	219,579	219,579	d)
Transportation	-	25,500	25,500	e)
OPEX	26,016	136,500	110,484	f)
Power	1,037	20,000	18,963	g)
Optimization operations	153,747	115,000	(38,747)	h)
General and administrative	104,284	112,980	8,696	
Bank interest	31,552	33,500	1,948	
Hedging losses	-	62,128	62,128	i)
Financial Advisory	20,000	20,000	-	
Restructuring	75,000	100,000	25,000	j)
	<u>411,636</u>	<u>845,187</u>	<u>433,551</u>	
Net cash flow	633,068	109,504	523,564	
Cash - beginning	199,049	191,000	8,049	k)
Cash - closing	<u>832,117</u>	<u>300,504</u>	<u>531,613</u>	

19. The Company experienced positive cash flow of approximately \$633,000 from the Filing Date through to March 17, 2019, which resulted in a favourable overall variance of approximately \$524,000 in comparison to the Initial Forecast. The Monitor offers the following comments in respect of certain of the above noted individual line item variances:

- a) The positive variance of approximately \$62,000 in respect of production revenues is the result of the inclusion of approximately \$19,000 of partners' share of revenues which will be subject to remittance to partners in due course and improved pricing and differentials narrowing.

- b) The Initial Forecast assumed an overall neutral effect of GST collected, paid and remitted.
- c) For purposes of conservatism, Management did not contemplate the collection of any accounts receivable in the Initial Forecast resulting in a positive variance of approximately \$12,000.
- d) The Initial Forecast contemplated payment of royalties associated with December revenues; however, based on the subsequent advice of its legal counsel, Management is treating all pre-filing related royalties as being stayed to be addressed as part of the Elcano Group's overall restructuring plan in due course giving rise to a positive variance of approximately \$220,000. Based upon advice received from the Monitor's legal counsel, the Monitor concurs with the Elcano Group's treatment of pre-filing royalties.
- e) The positive variance of approximately \$26,000 in respect of transportation expenses is the result of a timing difference arising from the fact that when preparing the Initial Forecast, Management anticipated truckers would alter the Company's ongoing payment terms and seek deposits or accelerated payments; however, to date such accelerated payment terms have not been requested, resulting in timing delays ("**Positive Timing Difference**"), with these timing differences to be reversed in due course.
- f) The positive variance of approximately \$110,000 in operating expenses is also the result of a Positive Timing Difference.
- g) The positive variance of approximately \$19,000 in respect of power expenses is also the result of a Positive Timing Difference.



- h) The negative variance of approximately \$39,000 in respect of the Program is the result of certain suppliers requesting deposits in excess of that as anticipated by Management; however, Management advises that the overall cost estimate associated with the Program has not increased such that the effect of this timing difference will be reversed in due course.
- i) When preparing the Initial Forecast, Management forecasted payment of the ongoing monthly settlement of hedging losses to the Elcano Group's principal lender, National Bank of Canada ("NBC"). On February 28, 2019, the Mandatory Hedges (as defined in the Initial Pincock Affidavit) were terminated. Based upon advice received from its legal counsel, the Elcano Group is of the view that the Mandatory Hedges are "eligible financial contracts" as defined in the CCAA such that the termination thereof gives rise to a claim by NBC to be addressed in due course as part of the Elcano Group's restructuring plan, thereby eliminating the requirement to settle hedging losses on a monthly basis. However, the Monitor understands that the February settlement payment in the amount of approximately \$62,000 was effectively otherwise collected by NBC on February 25, 2019 by adding that amount to the final outstanding balance under EEI's line of credit as opposed to the contemplated cash payment provided for in the Initial Forecast. Consequently, a favourable variance of approximately \$62,000 was experienced. Based upon advice received from its legal counsel, the Monitor concurs with the Elcano Group's assessment and treatment of the Mandatory Hedges.
- j) The \$25,000 positive variance in respect of restructuring expenses is the result of a Positive Timing Difference that will be reversed in due course.
- k) The opening cash position set out in the Initial Forecast did not contemplate two cheques totalling approximately \$7,000 that had been deposited into the Elcano Group's new operating account prior to the Filing Date.

## CASH FLOW FORECAST

20. Management has prepared an updated cash flow forecast for the period March 18 to June 30, 2019 (the “**Revised Forecast**”) which is attached as Exhibit “4” to the Affidavit of Richard Fulton sworn on March 18, 2019 (the “**Fulton Affidavit**”) in connection with the CCAA Proceedings.
21. The Revised Forecast can be summarized as follows:

	<b>March 18 - June 30, 2019</b>
<b>Receipts</b>	
Production revenues	\$ 3,950,518
	3,950,518
<b>Disbursements</b>	
Royalties	459,113
Transportation	144,500
OPEX	602,000
Power	360,000
Optimization program	685,753
General and administrative	429,420
Insurance	40,000
Bank interest	132,180
Financial advisory	60,000
Restructuring	300,000
Professional fees	200,000
Critical suppliers	36,685
	3,449,651
Net cash flow	500,867
Cash - beginning	832,117
Cash - closing	\$ 1,332,984

22. The Monitor provides the following comments in respect of the Revised Forecast:
- a. Management has forecast positive cash flow of approximately \$501,000 from operations over the forecast period such that the requirement for interim financing is not contemplated.

- b. Management has assumed that all royalties due in relation to revenues associated with production prior to the Filing Date are stayed and will be addressed as part of the Elcano Group's ultimate restructuring plan in due course. Consequently, estimated royalty payments relating to February production revenues have only been contemplated in respect of production for the period February 26 - 28, 2019.
- c. "Financial Advisory" represents the monthly work fees of the Elcano Group's sales advisors, GMP FirstEnergy ("GMP").
- d. Forecasted "Restructuring" of approximately \$300,000 relates to the contemplated professional fees of counsel for the Elcano Group, the Monitor and the Monitor's legal counsel.
- e. Forecasted "Professional Fees" of approximately \$200,000 relate to the contemplated payment of fees incurred by NBC's professional advisors prior to the Filing Date. As such fees represent pre-filing obligations, the Elcano Group will be seeking the Court's authorization to settle these accounts. In light of the forecasted cash availability, the Monitor is supportive of this arrangement as agreed to between the Elcano Group and NBC.
- f. Forecasted payments to "Critical Suppliers" totalling approximately \$37,000 represents the payment of arrears for the months of January and February to three well operators of certain of the Elcano Group's properties in each of Manitoba, Alberta and Saskatchewan who Management deems are critical to the ongoing operations of the Elcano Group. Management is concerned about potential well safety concerns and the disruption to business operations should these individuals withhold services while other payment arrangements are put in place going forward. The Elcano Group will be seeking the Court's authorization to designate these individuals as critical suppliers and to make payment of the arrears. The Monitor is supportive of same in the circumstances.

## RESTRUCTURING ACTIVITIES

23. The Initial Order directed the establishment of a Sale and Investment Solicitation Process (the “SISP”) which Management anticipates will form the basis for the Elcano Group’s restructuring plan. Pursuant to the SISP, the Elcano Group is soliciting interest in and opportunities for a sale of all or part of its Property or for an investment in, restructuring, recapitalization, refinancing or other form of reorganization of all or part of the Elcano Group or its business.
24. Pursuant to the terms of the Initial Order, the Elcano Group engaged GMP as its sales advisor to administer the SISP.
25. The terms of the SISP provided that GMP was to complete the following initial steps by March 8, 2019:
  - Cause notice of the SISP to be published in the *Daily Oil Bulletin*;
  - Issue a press release advising of the SISP;
  - Distribute a summary teaser letter outlining the SISP and the opportunity to potential bidders; and
  - Compile and make available a virtual data room.
26. GMP accomplished all of the above by March 8, 2019 as well as caused notice of the SISP to be published in the *Globe & Mail*.
27. As of the date of this First Report, GMP has advised the Monitor that it is satisfied with the initial administration of the SISP. Additional details in respect of the parties expressing initial interest in the opportunity as prepared by GMP are included in Confidential Exhibit “1” of the Fulton Affidavit (the “**Confidential Exhibit**”). As the Confidential Exhibit includes commercially sensitive information, the Elcano Group will be seeking a sealing order over the Confidential Exhibit until the conclusion of these CCAA Proceedings. The Monitor is supportive of such request.

### **CLAIMS PROCESS**

28. Management is seeking the establishment of a claims process to determine, identify and confirm the claims against the Elcano Group.
29. The Monitor believes that the establishment of a claims process at this time is appropriate in the circumstances, as it will assist the Elcano Group with the identification of all of its creditors and their respective claims. This will allow the Elcano Group to facilitate distribution of any proceeds arising from the SISP or lead to the formulation of a restructuring plan following the SISP.
30. The Monitor is of the view that the procedures proposed by the Elcano Group, which procedures have been developed in consultation with the Monitor, provide reasonable timelines for the claims of creditors to be submitted and considered with the key dates being as follows:
  - April 5, 2019 – issuance of claims packages to creditors; and
  - May 13, 2019 – claims bar date.
31. Further details regarding the proposed claims process can be found at paragraphs 21 - 23 of the Fulton Affidavit.

### **STAY EXTENSION**

32. The SISP has deadlines for submission of non-binding letters of intent (defined in the SISP as a "Phase 1 Qualified Bid") by April 26, 2019 and submission of binding offers in the form of a purchase and sale agreement (defined in the SISP as a "Phase 2 Qualified Bid") by May 17, 2019. Further, the SISP timeline contemplates completion of confirmatory title and environmental due diligence and execution of purchase and sale agreement(s) in respect of Successful Bid(s) (as defined in the SISP) by June 3, 2019, with Court approval of the Successful Bid(s) by June 12, 2019 and closing of the contemplated transaction(s) by June 14, 2019.

33. The Elcano Group is seeking a requested extension of the Stay through to June 14, 2019 which correlates with the SISP timeline and proposed closing of a resulting transaction(s) by June 14, 2019.
34. The Elcano Group proposes to provide all the Phase 1 bids and all the Phase 2 bids to NBC, on a confidential basis, after the respective bid deadlines. This will afford NBC the opportunity to consider its alternatives if it is not satisfied with the status of the SISP as it relates to NBC's position at the respective deadlines.

### CONCLUSIONS AND RECOMMENDATIONS

35. The Monitor is satisfied that Management has been acting with due diligence and in good faith in working towards a successful restructuring.
36. The Revised Forecast estimates that the Elcano Group will generate sufficient funds from operations such that interim financing will not be required through to June 30, 2019.
37. In light of the above, the Monitor recommends that this Honourable Court:
  - Authorize the extension of the Stay through to June 14, 2019;
  - Authorize the contemplated payments to NBC's professional advisors as set out in this First Report;
  - Recognize the three operators as critical suppliers and authorize the contemplated payments thereto as set out in this First Report;
  - Direct that the Confidential Exhibit be sealed until the conclusion of the CCAA Proceedings; and
  - Approve the proposed claims process as described in the Fulton Affidavit.

All of which is respectfully submitted this 18<sup>th</sup> day of March, 2019.

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

  
Per: Marc Kelly  
Senior Vice President

# APPENDIX “A”

March 1, 2019

**To the Creditors of Elcano Exploration Inc., Elcano Exploration Ltd. and Elcano Energy Partnership (collectively referred to as the "Elcano Group")**

Dear Sirs/Mesdames:

**Re: Proceedings under the *Companies' Creditors Arrangement Act***

TAKE NOTICE that Elcano Exploration Inc. ("EEI") and Elcano Exploration Ltd. ("EEL") made an application to the Court of Queen's Bench of Alberta (the "Court") seeking protection from their creditors under the *Companies' Creditors Arrangement Act* (the "CCAA"). On February 26, 2019 a CCAA Initial Order and SISP Approval order (the "CCAA Order") was granted by the Honourable Madam Justice K.M. Horner of the Court. The Court appointed Hardie & Kelly Inc. as Monitor of the Elcano Group (the "Monitor").

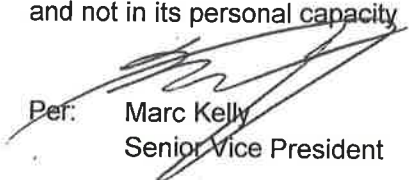
The CCAA Order grants various relief to EEI and EEL, as well as to the Elcano Energy Partnership, including, but not limited to, the imposition of an initial *Stay of Proceedings* (the "Stay of Proceedings") against the Elcano Group and their assets through to March 28, 2019 and provides the Elcano Group with an opportunity to prepare and file a plan of arrangement or compromise under the CCAA for the consideration of its creditors. Consequently, claims against the Elcano Group for payment for goods and services supplied to the Elcano Group prior to February 26, 2019 are suspended and creditors are prohibited from continuing or taking any actions or exercising any rights against the Elcano Group or the Monitor, except with leave of the Court. Under the CCAA Order, the Elcano Group is to continue to carry on business in a manner consistent with the commercially reasonable preservation of its business and assets while it engages in a Court supervised *Sale and Investment Solicitation Process* ("SISP").

A copy of the CCAA Order and a list of the names and addresses and amounts due to the Elcano Group's creditors as estimated by management of the Elcano Group can be found on the Monitor's website (the "Website") at <https://relieffromdebt.ca/elcano-group/> or by contacting the Monitor directly. **You are not required to file a proof of claim at this time.** A formal claims process is expected to be initiated in due course.

Additional materials will be posted to the Website from time to time. The next Court application in the proceedings is scheduled for March 28, 2019. Creditors are encouraged to check the Website regularly for updates as to the status of the proceedings. Should you have any questions or concerns please contact Mr. Richard Fulton, President & CEO of the Elcano Group, at 403-460-4188 ext. 679, or the undersigned at 403-536-8510.

Yours truly,

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

Per:   
Marc Kelly  
Senior Vice President



# **APPENDIX “B”**

Court File Number 1901-02578

IN THE COURT OF QUEEN'S BENCH OF ALBERTA  
JUDICIAL CENTRE OF CALGARY

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

AND IN THE MATTER OF  
ELCANO EXPLORATION INC., ELCANO EXPLORATION LTD. and ELCANO  
ENERGY PARTNERSHIP

On February 26, 2019, the Court of Queen's Bench of Alberta (the "Court") granted a CCAA initial Order and SISP Approval order (the "Initial Order") under the Companies' Creditors Arrangement Act providing for an initial stay of proceedings through to March 28, 2019. Hardie & Kelly Inc. was appointed as monitor (the "Monitor"). The Initial Order can be accessed by referring to the Monitor's website at <https://relieffromdebt.ca/elcano-group/> (the "Website"). Interested parties are encouraged to check the Website periodically for updates as to the status of the proceedings and the Sale and Investment Solicitation Process ("SISP"). For further information contact Marc Kelly, of Hardie & Kelly Inc., at 403-536-8510 or by e-mail at [mkelly@insolvency.net](mailto:mkelly@insolvency.net)

**Hardie & Kelly**

**LICENSED INSOLVENCY TRUSTEE**

110, 5800 - 2nd Street SW, Calgary, AB, T2H 0H2  
Tel: 403-777-9999 Fax: 403-640-0591