Action No. 0901-01613

IN THE COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL DISTRICT 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 THE *BUSINESS CORPORATIONS ACT*, R.S.A 2000, C. B 9, AS AMENDED;

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF OILEXCO INCORPORATED AND OILEXCO TECHNICAL SERVICES INC.

FIRST REPORT OF THE MONITOR

ERNST & YOUNG INC.

FEBRUARY 10, 2009

INTRODUCTION

1. On February 5, 2009, Oilexco Incorporated ("Oilexco") and Oilexco Technical Services Inc. ("OTSI") (each an "Applicant" or collectively, "the Applicants") filed for and obtained protection from their creditors under the *Companies' Creditors Arrangement Act*, R.S.C. 1985 c. C-36, as amended, (the "CCAA") pursuant to an order of this Honourable Court dated February 5, 2009 (the "Initial Order").

2. Pursuant to the Initial Order, Ernst & Young Inc. was appointed monitor of the Applicants during these CCAA proceedings (the "Monitor").

3. The first report of the Monitor (the "First Report") is submitted to this Honourable Court in connection with the Applicants' motion for approval of the Employee Retention Plan ("ERP").

TERMS OF REFERENCE

4. In preparing this First Report, the Monitor has relied upon unaudited financial information, company records and discussions with management of the Applicants as well as discussions with legal counsel for the Applicants and the Royal Bank of Scotland ("RBS"). The Monitor has not performed an audit, review or other verification of such information.

5. Capitalized terms not defined in this First Report are as defined in the Initial Order. All references to dollars are in Canadian currency unless otherwise noted.

BACKGROUND

6. Background to the Applicants is contained in the materials filed relating to the Initial Order and include the affidavit of Mr. Arthur Mullholland sworn February 4, 2009. These documents, together with other information regarding the CCAA proceeding, including the Initial Order and supporting affidavits have been posted by the Monitor on its website at:

http://documentcentre.eycan.com/Pages/Main.aspx?SID=99

7. Oilexco is an oil and gas exploration and production company and is the 100% shareholder of Oilexco North Sea Limited ("ONSL"). On January 7, 2009, ONSL applied for and was granted an Order in the High Court of Justice, Chancery Division, Companies Court, London, United Kingdom, for an Order appointing Alan Robert Brown, Roy Bailey, Colin Peter Dempster, and Thomas Merchant Burton of Ernst & Young LLP as joint administrators (the "Administrators") of ONSL. The Administrators have retained Morgan Stanley & Co. Limited ("Morgan Stanley") for the sale of ONSL or some of its assets in such a way as to maximize the value of the assets for all stakeholders, and maintain the business, its employees and system as a going concern (the "ONSL Sale Process").

8. We have been advised by the Administrators that they are actively marketing the assets of ONSL and have received a first round of indicative bids.

9. The RBS, having issued demands of the Applicants with respect to a guarantee of the obligations of ONSL, would appear to be a significant creditor of the Applicants.

10. The Applicants have also guaranteed the obligations of ONSL to several oilfield service contractors.

11. On the date of this report, the Applicant provided the Monitor with the list of creditors and addresses; however there has been insufficient time to complete the mailing of the notice of the Initial Order to the creditors. As such, creditors have not received notice of this CCAA proceeding.

REQUEST FOR AN EMPLOYEE RETENTION PLAN (THE "ERP")

12. As set out in the Applicants' Notice of Motion (Re: Employee Retention Plan) returnable on February 11, 2009 and the proposed Employee Retention Plan provided to the Monitor on February 10, 2009 by legal counsel for the Applicants, the Applicants are seeking this Honourable Court's approval of the proposed ERP with respect to substantially all of their employees. The intention of the ERP is to ensure that those employees determined as essential to the continuation of the operations and a successful restructuring are retained (the "Employees").

13. As set forth in the affidavit of Arthur Mullholland sworn February 4, 2009 in support of the application for the Initial Order, the Applicants have entered into a Services Agreement dated January 15, 2009 with ONSL and the Administrators to provide certain accounting and other services (the "Service Agreement").

14. In addition to the monthly fee of US$ 1.9 million, as contemplated under the Service Agreement, a bonus payment in the sum of US$ 2 million is payable by ONSL to the Applicants (the "Bonus Payment") under certain conditions. The Bonus Payment is payable no later than 5 days after the date that the Administrators complete the sale of ONSL and/or the significant majority of its assets (the "Success Date"). No Bonus Payment shall be payable if the Services Agreement is terminated prior to a sale. The Service Agreement does not allocate the Bonus Payment for any specific use.

15. Based upon our initial review of the Cash Flow Forecast prepared by the Applicants and attached as Exhibit "L" to the affidavit of Arthur Mullholland sworn February 4, 2009 in support of the application for the Initial Order, the Applicants anticipate an ending balances of approximately $7.4 million as at April

30, 2009, before taking into account the estimated Bonus Payment of US$ 2 million (CDN$ 2,400,000).

NEED FOR AN ERP

16. The Applicants' view is that their ability to reorganize depends on the continued employment, active participation and dedication of the Employees who possess the knowledge, experience and skills necessary to support the daily operations.

17. It is also the Applicants' view that the Employees are particularly crucial to the effective execution by the Applications of their duties under the Services Agreement.

18. The Monitor has been advised that the Employees have been anxiously awaiting details of the ERP and that concerns currently exist with respect to job security and compensation. The loss of certain Employees could create further stability concerns, potentially leading to additional departures and creating a momentum of attrition.

METHODOLOGY IN DEVELOPING THE ERP

19. The Employees and their respective ERP payouts were established by the Applicants' senior management based on six months base salary for those employees included in the ERP.

SUMMARY OF ERP

20. The ERP covers 38 Employees and assumes a total payment of approximately $4,127,716. The ERP is to be funded from the Cash Pool and Bonus Pool as defined and discussed below. For greater certainty, the Monitor understands that $2 million of the ERP will be funded from cash on hand of the Applicants with the remaining $2 million of it from the Bonus Payment to be received from the Administrators; however if the Bonus Payment is not received, the entire ERP will be funded by the Applicants' cash on hand.

21. The basic terms of the ERP pursuant to a draft of the proposed ERP in their materials provided to the Monitor on February 9, 2009 by legal counsel for the Applicants are as follows:

EMPLOYEE RETENTION PLAN

A. When used herein, the following terms shall have the following meanings:

(i) "**Cash Pool**" means the sum of $2 Million;

(ii) "**Bonus Payment**" means the US$2 Million payment to be paid to Oilexco Incorporated by the Administrators on the Success Date under and pursuant to the Services Agreement;

(iii) "**Retention Date**" means the date that is five (5) business days following the Success Date;

(iv) "**Services Agreement**" means the Agreement dated January 15, 2009 between Oilexco Incorporated, Oilexco Technical Services Inc., Oilexco North Sea Limited (In Administration) and Alan Robert Bloom, Roy Bailey, Colin Peter Dempster and Thomas Merchant Burton.

Other capitalized terms utilized herein and not otherwise defined shall be ascribed the same meaning as in the Services Agreement.

B. Unless terminated for cause, those Service Employees who have not resigned and who remain employed with Oilexco Incorporated or Oilexco Technical Services Inc., as the case may be, will receive a retention bonus (the "Retention Bonus") drawn from the aggregate of the Cash Pool and Bonus Payment to be allocated and distributed as set forth Schedule "A" hereto, payable on the Retention Date.

C. For greater certainty, with respect to the Retention Bonus:

(i) if the employment of a Service Employee is terminated by their employer other than for cause prior to the Success Date, which termination may only occur with the consent of the Monitor, such Service Employee shall receive his/her Retention Bonus;

(ii) if a Service Employee resigns or is terminated for cause prior to the Retention Date, such Service Employee will not be entitled to receive the Retention Bonus; and

(iii) if the Retention Date occurs and the Bonus Payment has not yet been paid to Oilexco Incorporated, then a portion of the Retention Bonus consisting of the Cash Pool shall be paid to the Service Employees on a prorated basis with the balance of the Retention Bonus to be paid within five (5) business days of receipt of the Bonus Payment.

D. For the purpose of securing payment of the Bonus Payment, Oilexco Incorporated and Oilexco Technical Services Inc. shall apply to the Court in the CCAA Proceedings seeking a charge over the assets of Oilexco Incorporated. If Oilexco Incorporated is unable to pay the Retention Bonus in full, then the amount of funds available to fund the Retention Bonus shall be allocated among the Service Employees on a *pro rata* basis.

ERP REVIEW AND ANALYSIS

22. The Monitor is advised that RBS is not supportive of the terms of the proposed ERP and will be requesting an adjournment of these proceedings.

23. The Monitor has not been in contact with representatives of any of the major stakeholders of these proceedings nor have such parties been advised of the terms

of the proposed ERP, other than RBS. As notice of these proceedings has not been provided, it is likely that there are creditors who may not be aware of these CCAA proceedings and specifically of this application. The Monitor understands that the Applicants have provided guarantees to creditors who may have significant claims against the Applicants.

24. In light of the limited time available, the Monitor has not been able to conduct its normal review in order to assess the reasonableness of the proposed ERP, including but not limited to:

    (i) Consider the current market conditions and discuss with local human resource consulting firms the ability of the employees to attain comparable employment;

    (ii) Compare the Applicants' proposed ERP terms to ERP's authorized in recent CCAA and Chapter 11 filings;

    (iii) Discuss the appropriateness of the ERP with significant stakeholders; and

    (iv) Determine the appropriateness of the ERP relative to the as yet undisclosed plan of arrangement.

MONITOR'S RECOMMENDATION

25. The Monitor understands that the Applicants' primary business operation is to provide services as contemplated under the Service Agreement, namely providing technical and administrative support to the UK operations.

26. Furthermore, the Monitor understands that the Applicants' management negotiated the terms of the Service Agreement with the Administrators including the Bonus Payment. The Monitor understands that the Service Agreement, and the agreed upon funding amounts, were negotiated to provide adequate compensation by the Administrators to the Applicants for the services to be provided by the Applicants.

27. While the Monitor can understand some urgency to establishing an ERP, the Monitor believes it is premature at this time to seek the ERP as contemplated by the Mulholland Affidavit sworn February 10, 2009 given the following:

    (i) All the creditors have not been provided the statutory notice of the Initial Order;

    (ii) The Monitor has not had sufficient time to evaluate the merits of the ERP;

    (iii) The Monitor has not had sufficient time to assess the business of the Applicants; and,

    (iv) The Monitor understands that RBS is not supporting the payment of additional amounts beyond what was agreed to in the Services Agreement.

28. Notwithstanding the above comments, the Monitor would support a US$ 2 million ERP payment which would be subject to and have a charge over the receipt of the Bonus Payment from the Administrator for the following reasons:

    (i) The Bonus Payment represents an asset to the Applicants that is derived from the efforts of the employees; and

    (ii) The negotiated Bonus Payment results from the services under the Service Agreement and the Bonus Payment would not be available for the general body of creditors but for the participation in the ONSL Sale Process.

All of which is respectfully submitted this 10th day of February 2009.

ERNST & YOUNG INC.
In its capacity as Court Appointed
Monitor of the Applicants

Greg Pollard, CA, CIRP
Senior Vice President

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FIRST REPORT OF THE MONITOR
ERNST & YOUNG INC.
February 10, 2009

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