

Action No. 0901-07221

**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 MAHALO ENERGY LTD.**

**THIRD REPORT OF THE MONITOR  
ALGER & ASSOCIATES INC.**

**AUGUST 18, 2009**

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## INTRODUCTION

1. On May 21, 2009, Mahalo Energy Ltd. (“Mahalo” or the “Company”) filed a petition pursuant to the provisions of the *Companies’ Creditors Arrangement Act* (“CCAA”) in the Court of Queen’s Bench of Alberta (the “Court”). On May 22, 2009 the Court granted an order (the “CCAA Initial Order”), which, amongst other things, appointed Alger & Associates Inc. as Monitor (“Monitor”) of Mahalo.
2. The Monitor’s first report dated June 18, 2009 provided this Honourable Court with preliminary information on Mahalo’s affairs, a status update on Mahalo’s restructuring efforts for the period ending June 12, 2009 and the application for an extension of the stay period to July 30, 2009.
3. Copies of certain relevant information related to these proceedings, including the Initial Order, the Petition and the supporting affidavit of Mr. James Burns, the President of Mahalo, may be obtained from the Monitor’s website (<http://www.alger.ca/engagements.htm>).
4. All defined terms from the Monitor’s previous reports are applicable to this third report.
5. The purpose of the Monitor’s Third Report is to provide this Honourable Court with:
  - a) Updated information on Mahalo’s operations and restructuring activities since the filing of the Monitor’s Second Report;
  - b) Summary of Statement of Receipts and Disbursements for the period ending August 14, 2009; and
  - c) Review of the proposed sale of the Company’s Assets to Trafina.

### Limitations of Report

6. The information contained in this report has been obtained from the records of Mahalo and is based upon discussions with, and representations made by, management.

### POST CCAA OPERATIONS

#### Operations

7. The remaining Canadian oil and gas operations are the subject of a purchase and sale agreement, with an effective sale date of July 1, 2009. Mahalo will be collecting post-CCAA revenue and paying post-CCAA expenses for the period up to the effective date of the sale. The sale of assets is discussed further in Paragraph 15.

#### Cash flow for period ended August 14, 2009

8. Attached as Exhibit "1" is a detailed analysis of Mahalo's actual versus budgeted cash flow for the period ended August 14, 2009. A summary comparison of the actual versus budgeted cash flow for the twelve week period from May 21, 2009 to August 14, 2009 is as follows:

Mahalo Energy Ltd. Actual vs. Budgeted Cashflow			
For the Period Ending August 14, 2009	Actual	Budget	Variance Positive/ (Negative)
Opening Cash on hand	\$59,798	59,798	-
Cash Receipts	1,223,121	1,381,034	(157,913)
Cash Disbursements	(1,077,226)	(1,499,206)	421,980
Closing Cash on Hand	\$205,693	(58,374)	264,067

Cash Receipts

9. The actual operating cash receipts for the twelve week period were the same as those contained in the revised budget. The variance relates to the receipt of the management fees from Mahalo USA. Due to the timing of the Chapter 11 US Court hearings and approval of interim DIP funding, management fees were not paid during the period since the Monitor's Second Report. The US Courts have now permitted the payment of management fees to Mahalo by Mahalo USA from Mahalo USA's cash collateral on an interim basis.

Cash Disbursements

10. The actual cash disbursements for the twelve week period were approximately \$422,000 less than that contained in the revised budget arising from four major factors:
  - a) Payments to the Company's solicitors and the Monitor and its counsel were \$220,000 less than budgeted due to the timing of the payment of the invoices sent by the legal counsel and the Monitor and its legal counsel. Actual fees for the period will still be less than budgeted.
  - b) The actual rent expense to August 14, 2009 is less than budgeted by \$91,000 due to an over budgeting of rental payments and the application of the lease deposit against rental expense.
  - c) Other administration costs, comprising primarily salaries, consulting and related costs, were approximately \$56,000 less than the budgeted figure.
  - d) The operating expenses and a power prepayment were approximately \$54,000 less than those contained in the budget.

Expenditure Variances in Excess of 15% of Budget

11. Pursuant to Clause 26 (b) of the CCAA Initial Order, line item expenditure variances greater than 15% of the budgeted expense are required to be reported to the Lenders and the Court.
12. There are two line item expense variances in excess of 15%: unbudgeted pipeline discontinuation charges for \$12,693 and other G&A expenses of \$3,209. As previously reported the pipeline discontinuation expense costs were incurred in order to remain in compliance with ERCB regulations and thereby permit the sale of the Canadian oil and gas assets to be completed. The Lenders have approved the discontinuation costs.

**Cash Flow Budget for period to October 30, 2009**

13. The Company prepared a revised cashflow budget for the period ending October 30, 2009, which was attached as Exhibit "2" to the Monitor's Second Report. Based on actual results to August 14, 2009, and budgeted cashflow to October 30, 2009, the Company remains in a cash positive position.
14. As outlined in the May 21, 2009 affidavit of James Burns, the management fee from Mahalo USA is to be funded from the Mahalo USA Chapter 11 DIP funding. The Chapter 11 DIP funding has not received final Court approval at the date of this report. The receipt of any management fees beyond the week ending August 28, 2009 are subject to the discretion of the US Courts.

**SALE OF OIL & GAS ASSETS**

15. As mentioned in the Monitor's Second Report, the Company has entered into a purchase and sale agreement ("Trafina PSA") with Trafina Energy Ltd. and Sedna Oil & Gas Ltd. (collectively "Trafina") to sell all of the Canadian oil and gas assets owned by the Company. The Trafina PSA requires Court approval prior to closing.

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16. The Monitor has reviewed:
  - a) the final draft of the Trafina PSA and the Monitor has been advised by the Company that no material changes have been made to the executed agreement;
  - b) the reserve report prepared by Netherland Sewell and Associates, Inc. as at December 31, 2008 and dated March 20, 2009; and
  - c) the draft affidavit of Mr. David Burton, chief executive officer of Mahalo, prepared for the Court application to approve the sale to Trafina.
  
17. Based on the review of the above mentioned documents and other material, the Monitor supports the sale of the Canadian oil and gas assets to Trafina for the following reasons:
  - a) Since June 2008 the Company has, through various agents, conducted a thorough, but still unsuccessful, marketing process for the assets;
  - b) The values attributed to the reserves by Netherland Sewell and Associates, Inc. combined with the response of the marketing efforts to date support the value given to the assets in the sale to Trafina;
  - c) Although no net sale proceeds will be realized on the sale of the Canadian oil and gas properties, the prospective purchaser has agreed to assume all abandonment liabilities for the associated wells, which is a condition required by the regulators for their approval of the transfer of the well licenses. The Company has recorded in its March 31, 2009 consolidated financial statements an asset retirement obligation of \$1.9 million related to these Canadian oil and gas properties;
  - d) In addition to the assumption of the liabilities mentioned above, the Company will also receive a gross overriding royalty on future production from the properties;

- e) The Canadian oil and gas properties operate at approximately a break-even netback basis and at a loss after administration costs are factored in; and
  - f) The Company will be able to reduce its complement of employees and consultants following the sale of the properties.
18. The effective date for the Trafina PSA is July 1, 2009 and a statement of adjustments will be required to complete the transaction. The Monitor is of the understanding that there will no material adjustments required.
19. The Lenders also support the sale of Mahalo's Canadian oil and gas assets to Trafina.

#### **Mahalo USA Chapter 11 Proceedings**

20. The disclosure below has been provided by David Burton and US legal counsel.
- a) Mahalo USA has been attempting to stabilize its operations, reduce its overhead, and negotiate agreed resolutions of disputes with major creditors while in Chapter 11.
  - b) A summary of certain matters, and the objections and responses thereto, were heard by the U.S. Bankruptcy Court on August 13, 2009 as follows:
    - i. Mahalo USA's Motion for Order authorizing the interim use of cash collateral was granted with a final hearing set for September 2, 2009;
    - ii. Mahalo USA's motion for non-insider retention plan was granted, allowing one week's salary for every month employed by debtor post-petition;
    - iii. SemGas, L.P.'s Motion to set a time for the debtor to assume or reject an executory contract with SemGas, L.P., including a requirement to cure payment of a pre-petition claim of approximately \$200,000 was denied but could be re-filed at a later date;

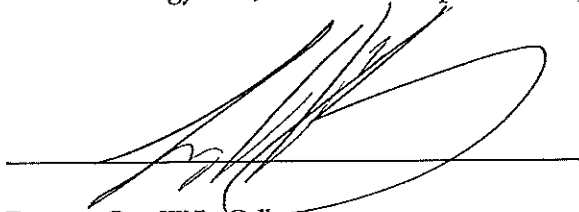
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- iv. Mahalo USA's proposed adequate protection agreement for payment of post-petition payments to SemGas was granted; and
- v. The US Court did send a clear signal that it is looking for "progress" in the case and anticipates eventually setting it for hearing under Section 105 of the US Bankruptcy Code.

Respectfully submitted on this 18<sup>th</sup> day of August, 2009

**Alger & Associates Inc.**

In its capacity as Court Appointed Monitor of  
Mahalo Energy Ltd., and not in its personal capacity.

A handwritten signature in black ink, appearing to read 'Guy W.L. Odhams', is written over a horizontal line. The signature is stylized and cursive.

Per: Guy W.L. Odhams  
Senior-Vice President

**Mahalo Energy Ltd.**  
**Cash Flow Budget vs. Actual Canadian Operations**  
**for the Period May 21, 2009 to August 14, 2009**  
**(Canadian \$)**

**EXHIBIT 1**

	Cumulative		Variance	
	Budget	Actual	In \$'s	% of budget
Opening Cash on hand	\$ 59,798	\$ 59,798	\$0	0.0%
<b>Canadian Revenue</b>				
GORR Revenue				
Anticipated cash receipt (Sale of Surplus Junk)	609,995	609,995	(\$0)	0.0%
Repayment to Ableco	(256,780)	(256,080)	\$700	-0.3%
Production Revenue	241,041	241,290	\$249	0.1%
<b>Operating Disbursements</b>				
Transaction Costs of Canadian Sale	(48,000)	(44,969)	\$3,031	-6.3%
Pipeline discontinuations	-	(12,693)	(\$12,693)	0.0%
Operating Expense	(163,769)	(130,802)	\$32,967	-20.1%
Power prepayment	(30,000)	-	\$30,000	-100.0%
<b>Net Revenue</b>	<b>352,487</b>	<b>406,740</b>	<b>54,253</b>	<b>15.4%</b>
<b>G&amp;A Disbursements</b>				
Canadian Rent	(194,000)	(102,722)	\$91,278	-47.1%
Canadian Payroll and consultants	(333,947)	(323,227)	\$10,720	-3.2%
Canadian Benefits	(20,079)	(11,651)	\$8,428	-42.0%
Listing fee	(7,500)	(7,875)	(\$375)	5.0%
Travel	(36,140)	(25,565)	\$10,575	-29.3%
Meals and entertainment	(7,230)	(3,810)	\$3,420	-47.3%
Stationary	(3,010)	(2,103)	\$907	-30.1%
Communication	(14,460)	(11,894)	\$2,566	-17.7%
insurance (assumed paid in USA)	-	-	\$0	0.0%
Computer license rentals	(7,228)	(7,729)	(\$501)	6.9%
Severance/Vacation Pay	(27,580)	(6,000)	\$21,580	-78.2%
Bank Fees	(2,410)	(400)	\$2,010	-83.4%
Other G&A	(14,950)	(18,159)	(\$3,209)	21.5%
<b>Total Disbursements</b>	<b>\$ (668,534)</b>	<b>\$ (521,136)</b>	<b>\$147,398</b>	<b>-22.0%</b>
<b>Total Cashflow before Management Fee</b>	<b>\$ (316,047)</b>	<b>\$ (114,396)</b>	<b>\$201,651</b>	<b>-63.8%</b>
Management fee	529,998	371,836	(\$158,162)	-29.8%
Professional Fees:				
BDP				
Retainer				
Fees (\$250,000 less Retainer of \$85,000)	(206,666)	(71,761)	\$134,905	
Alger				
Retainer				
Fees (\$160,000 less retainer of 35,000)	(125,457)	(39,785)	\$85,672	
Cash on Hand	\$ (58,374)	\$ 205,692	\$ 264,065	-452.4%

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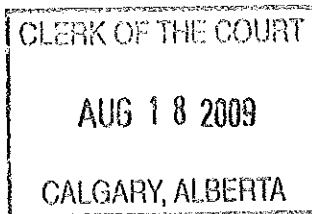
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