

D. Gray #6
Sworn: April 28, 2009

No. S-088488
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

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

AND

IN THE MATTER OF THE *Canada Business Corporations Act*
R.S.C., 1985 c. C-44

AND

IN THE MATTER OF HYDROXYL SYSTEMS INC.

PETITIONER

AFFIDAVIT

I, DAVID GRAY, CA-CIRP, of 1000 - 570 Granville Street, Vancouver, British Columbia,
MAKE OATH AND SAY AS FOLLOWS:

1. I am the President of The Summit Group Business Consultants Ltd. ("Summit") and, as such, I have personal knowledge of the matters hereinafter deposed to, except where stated to be on information, in which case, because of my belief in the veracity of the informant I identify, I believe both the information and the resulting statement I make to be true.
2. Capitalized terms used in this Affidavit have the same meaning as ascribed to them in my

earlier Affidavits in this proceeding.

3. I submit this Affidavit in support of an application by the Petitioner for a further extension of the stay of proceedings first granted to the Petitioner on December 5, 2008, to June 11, 2009, or such other date as the Court may approve.

Overview

4. The Petitioner continues to operate normally. Since the date of my last Affidavits, the Petitioner has secured one new contract (with Agnico Eagle Mines), which has assisted with its cash flow.
5. The Petitioner continues to employ 15 people from its main premises in Victoria. It has returned approximately half of that space to the landlord.
6. In addition to new projects, the Petitioner continues to work on existing projects, including its ongoing work with the Aker yard in Finland.
7. The Petitioner remains hopeful that it will be able to commence work on the Puerto Rican brewery project that I have reported on in previous Affidavits, although unfortunately at the time of preparing this Affidavit that project appears to be on hold.
8. Further, the Inland Empire Paper ("IEP") contract, which the Petitioner had hoped to obtain, has been awarded to a competitor, Siemens.
9. If the Petitioner does not soon secure a major new project, I expect that it will be necessary to further reduce the Petitioner's work force.

Cash Flow

10. For the time being, the Petitioner is continuing to operate within the terms of its line of credit arrangement with the Royal Bank, which is fully guaranteed by Mr. Croft, and is continuing to pay all of its post-filing creditors on a current basis.

11. Now shown to me and marked as Exhibit "A" to this my Affidavit is a projected cash flow for the Petitioner for the 10-week period ended June 19, 2009.
12. The cash flow also shows that, on a projected basis, even if the Petitioner does not secure any new work this year, it should be able to continue to operate on a roughly break-even basis, and that it should be able to operate within the scope of its existing line of credit.

Prospective Purchasers

13. My partner Harvey Lee and I, in our role of assisting the Petitioner with finding an investor/buyer, have continued to supply potential investors with updated information, including budgets, cash flows and other requested documentation.
14. We have also, since the date of my last Affidavit, identified and had discussions with two new potential buyers.
15. To date, we have obtained one formal offer to purchase the assets of the Petitioner. However, in my view, the offer does not appropriately recognize the potential value of the Petitioner's tax losses, and does not represent the best offer that (I believe) can be obtained.
16. The existing offer, in essence, is for the purchaser to acquire the assets of the Petitioner for a nominal amount, together with a covenant to complete the Petitioner's existing contracts with Aker and Letterkenny, and to remit a portion of the net proceeds from those contracts to the Petitioner, for distribution to its creditors. Because the transaction would be structured as an asset sale, no value would be given for the Petitioner's tax losses.
17. Based on current projections, it is unlikely that there would be any significant proceeds left over for distribution to unsecured creditors, after re-payment of the Royal Bank's line of credit and payment to the BDC under the terms of the settlement agreement reached between BDC and the Petitioner.

18. In addition to the party from whom we have received the offer described above, we have had discussions with a large, Vancouver-based wastewater management and treatment company. This company has provided us with a written expression of interest, outlining the framework and conditions under which it would be prepared to purchase the assets of the Petitioner. Those conditions are similar to the ones described above. In addition, however, this party would have the ability to use, and has expressed an interest in acquiring, the Petitioner's tax losses.
19. More recently, we have had discussions with an Alberta-based wastewater treatment company with a business profile that is similar to that of the Petitioner, only on a much larger scale.
20. Based on my discussions with the president of this company to date, I believe that, like the Vancouver-based wastewater treatment company described above, the Alberta group would be interested in acquiring not only the Petitioner's assets, but also in proceeding with a transaction that would allow for the retention of the benefit of the Petitioner's tax losses.
21. At the time of swearing my last Affidavits, I expressed confidence that a satisfactory contract could be entered into by April 30, 2009. While I remain cautiously optimistic that a transaction can be concluded, I acknowledge that the Petitioner's inability to secure a major new contract such as the IEP contract, and the general ongoing economic downturn, have made it significantly more difficult to secure an offer that may generate a meaningful recovery for the Petitioner's creditors other than the Royal Bank and BDC.
22. Despite these negative factors, I remain hopeful that a deal can be reached that will generate value for creditors.
23. Based on current projections, on existing contracts alone the Petitioner expects net revenues in excess of \$1.1 million over the next two years. In addition, the Petitioner has accumulated tax losses of approximately \$8.8 million, which have a potential value of as

much as \$800 thousand to \$1.0 million over time to a qualified purchaser.

Plan of Arrangement

24. Based on the discussions that we have had with prospective purchasers, and the types of offers we have received and discussed, it is apparent that any Plan of Arrangement to be put forward by the Petitioner will, at best, provide for the establishment of a fund for unsecured creditors, to be funded over time from net proceeds realized from existing contracts and further amounts from tax loss benefits as and when realized.
25. Based on current projections, I would expect any Plan to provide for payments to creditors over a period of approximately 24 to 36 months.

Ongoing Litigation Matters

26. I am advised by Mr. Major that the hearing of the arbitration between the Petitioner and Kan-Pak was completed and that counsel have submitted extensive written briefs to the arbitrator, who is expected to render a decision in early June. (When I last reported, it was expected that an award would be rendered in early May; however, I understand that because of the length of the parties' submissions, the arbitrator now requires more time to render his award).
27. As for the patent matter in Finland which I reported on in my fifth Affidavit, I am advised by Mr. Major that the Petitioner has appealed from the decision of the Helsinki City Court. To date, the respondent in those proceedings, Kruger-Kaldenes, has not, to my knowledge, taken any steps to enforce the award of costs made against Petitioner in the original proceedings.

28. I am advised by Mr. Major, as well, that there are ongoing discussions between the parties with a view to reaching a negotiated settlement.

SWORN BEFORE ME at the City of)
Vancouver, British Columbia,)
on April 28th, 2009)

_____)
A commissioner for taking)
affidavits in British Columbia)

_____)
DAVID GRAY)

AFFIDAVIT #6 - GRAY.DOC

SCOTT A. TURNER
Barrister & Solicitor
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This is Exhibit "A" referred to in the Affidavit of **David Gray** sworn before me this 28th day of April 2009.

A commissioner for taking affidavits in British Columbia.

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AFFIDAVIT #6 OF DAVID GRAY

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