

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

and

IN THE MATTER OF THE CANADA BUSINESS CORPORATION ACT

and

IN THE MATTER OF HYDROXYL SYSTEMS INC.

Monitor's First Report

January 2, 2009

EXECUTIVE SUMMARY

It is the Monitor's view that the 30-day extension being sought by the Company will not materially prejudice any creditor and will increase the possibility of a successful restructuring. In particular:

- all post-filing obligations (including statutory remittances, employee-related payments and trade payments) are being paid in the usual and ordinary course;
- management has advised that Aker Yards Oy ("Aker") intends to pay approximately \$1.9 million on or about January 31, 2009, and a further \$530,000 at the end of April 2009, once the Company delivers further components to Aker in Finland;
- if the Company were to cease operations, it is very unlikely that the Company would recover the \$1.9 million receivable owing by Aker;
- Mr. Croft has provided a cash collateral to Royal Bank of Canada to partially secure the Company's operating line (authorized at \$500,000); and
- it appears that the Aker receivable may be insured by Export Development Canada, but the Monitor cannot at this point, determine whether that coverage will be in place if the Company ceases to operate.

INTRODUCTION AND OVERVIEW

On December 5th, 2008 (the “Filing Date”), Hydroxyl Systems Inc. (the “Company” or “Hydroxyl”) filed an application pursuant to the provisions of the *Companies Creditors Arrangement Act* (“CCAA”) and was granted an order (the “Initial Order”) by the Supreme Court of British Columbia (the “Court”). A copy of the Initial Order was sent to every known creditor of Hydroxyl on or about December 15th, 2008. In addition, a copy of the Initial Order has been posted on the Monitor’s website.

The details of the circumstances surrounding the Company’s filing under the CCAA, the causes of its financial difficulties, and the events leading up to the CCAA application are contained in the Petition and the Affidavit of Charles Croft (the “Affidavit”) filed in these proceedings. A copy of the Petition and the Affidavit were included in the creditor information sent to the creditors and are also available on the Monitor’s website.

Hydroxyl is a privately owned company based in Victoria, B.C., engaged in the wastewater treatment industry. The Company supplies wastewater treatment products and related systems to the recycling and reuse segment of that industry.

From inception to date, the Company has invested over \$24 million in the development and commercialization of number of related technologies, applications and systems including the Company’s core product, ActiveCell™, a moving-bed biofilm reactor (“MBBR”) carrier. Hydroxyl has successfully applied its MBBR technology to the municipal, industrial and marine sectors.

Hydroxyl began operations in 1993 and currently employs approximately 20 employees (the Company laid off 10 employees in November 2008).

As at the date of the Initial Order, the Company was completing several marine contracts with customers such as Royal Caribbean Cruises Ltd. (“RCCL”), B.C. Ferries and Aker Yards Oy (“Aker”).

Subsequent to the date of the Initial Order, the Company retained the contract services of the Summit Group (“Summit”) to assist it with its restructuring efforts.

For the year ended December 31, 2007, the Company had a net loss of \$2.9 million (before income taxes) on gross revenues of \$11.2 million. For the 10 months ended October 31, 2008, Hydroxyl had a net loss of approximately \$2.1 million (before income taxes) on gross revenues of \$6.1 million.

The decline in revenues and profitability can be attributed primarily to the following factors:

- a significant slow down in both the marine and industrial wastewater markets;
- the Company’s learning curve with respect to retro-fitting cruise ships and improperly specified systems;
- insufficient profit margins to cover overhead, product development and finance costs; and
- the inability to post necessary bonding requirements for municipal contracts.

Unless specifically noted, the information in this Report has been provided to the Monitor by the Company and not independently verified.

ROLE OF THE MONITOR

The Initial Order provided that Campbell, Saunders Ltd. be appointed as Monitor with powers and duties as described in the Initial Order. In general terms, the Monitor’s duties and powers include:

- To receive information regarding the Company's business and financial affairs that the Monitor deems relevant;
- To assist the Company in the preparation of cash flow projections and statements and other financial reports that may be required by the Company or the Court;
- To have full and complete access to the books and records of the Company;
- To ensure that the Company makes payment as prescribed in the Initial Order;
- To assist the Company in pursuing its financial and restructuring options;
- To report to the Court if it believes there has been a material adverse change in the Company's financial circumstances or lack of compliance with the Initial Order; and
- To report to the Court and to the creditors from time to time and not less than 2 days prior to a scheduled application before the Court.

In addition, subject to specified limits, the Monitor is empowered to approve payments for goods or services supplied prior to the date of the Initial Order, if the supplier is critical to the ongoing operation of the business.

The Monitor is also empowered to consent to the orderly sale of certain assets, lease, agreements or arrangements in order to facilitate the downsizing or restructuring of the Company.

Since the date of the Initial Order (December 5, 2008) the Monitor has:

- Forwarded a copy of the Initial Order, a copy of the Petition, a copy of the Notice of Hearing of Petition, and a copy of the Affidavit to every known creditor of Hydroxyl;

- Published a notice of the Company's CCAA filing in The Victoria Times Colonist and The Globe and Mail;
- Retained Lawson Lundell LLP as the Monitor's independent legal counsel;
- In addition to providing the creditors with copies of the Initial Order, the Monitor has had discussions with several of the Hydroxyl creditors;
- The Monitor has reviewed the Company's insurance policy and confirmed that it is in full force and effect;
- The Monitor has assisted Hydroxyl in preparing cash flow projections and ensured that the Company's books and records, particularly accounts payable, were up to date;
- The Monitor participated in several strategy meetings with Hydroxyl's management its legal counsel and Summit in order to consider the Company's restructuring options. A preliminary discussion of Hydroxyl's restructuring options is provided later in this Report.

FINANCIAL POSITION AT NOVEMBER 30, 2008

The balance sheet of the Company as at November 30, 2008, is enclosed as Appendix "A" of this report. This statement has been prepared internally by the Company based on the information available at the date of this report. The Monitor has not audited or otherwise verified the accuracy or completeness of this information.

Following are our comments on the significant assets and liabilities shown on the attached November 30, 2008, balance sheet:

Cash

As at November 30, 2008, the Company had a negative cash balance of approximately \$88,200 (from its Royal Bank operating loan).

Accounts Receivable

The Company's trade accounts receivable as at November 30, 2008, are summarized as follows:

Current (1 – 30 days)	3,239,000
30 – 60 days outstanding	81,700
61 - 90 days outstanding	208,800
> 90 days outstanding	<u>575,200</u>
	<u>4,104,700</u>

The above totals can be further broken down as follows:

Aker (1.955 million Euros)	3,165,200
RCCL	223,000
B.C. Ferries	42,200
Kan-Pak LLC (Ongoing Litigation)	<u>569,200</u>
	<u>3,999,600</u>

The Aker receivable of 1.955 million Euros was invoiced by the Company on November 30, 2008, pursuant to a verbal agreement made between the Company and Aker. However, based on recent discussions between Hydroxyl and Aker, we understand that Aker now intends to pay approximately C\$1.9 million on or about January 31, 2009, and a further \$530,000 at the end of April 2009, after the Company delivers further components to Aker in Finland.

The Company is owed approximately C\$500,000 from Kan-Pak LLC (“Kan-Pak), a US company, representing the outstanding balance with respect to a project completed by Hydroxyl in the United States. Kan-Pak is withholding payment claiming that Hydroxyl did not fully complete the contract – which Hydroxyl is denying. Hydroxyl has filed a lien against the project. Kan-Pak has filed a counter claim for approximately \$2.5 million.

The Company has confirmed that Hydroxyl has insurance coverage with Export Development Canada (“EDC”) for its trade accounts receivable – including the Aker receivable. The Monitor cannot at this point, determine what the limitations are on claims under this policy, but is making efforts to determine these issues.

Inventory

The net book value of the Company’s inventory was approximately \$196,000 (at cost) as at November 30, 2008, and primarily consisted of spare parts.

Patents and Licenses

The Company has registered patents in Canada and the United States in respect of its wastewater treatment system for use on marine vessels and land-based applications. Hydroxyl also has various registered trademarks in Canada and the United States.

Prior to the date of the Initial Order, the Company had issued licenses to two U.S. companies to sell its wastewater treatment systems to the industrial market.

The Company is currently involved in a patent infringement lawsuit in Finland which according to management, is likely to soon be resolved without any significant further legal costs. If a settlement is reached, the Company will acknowledge the patent held by the third party and will be able to continue to sell and install its wastewater systems.

Fixed Assets

The net book value of fixed assets of the Company as at November 30, 2008, was approximately \$361,000 and includes office furniture & equipment, computer software and research & testing equipment.

LIABILITIES

Secured Creditors

Royal Bank of Canada (“RBC”)

RBC provides two facilities to the Company: (1) an operating line of credit in the maximum amount of \$500,000; and (2) a \$1.8 million revolving term loan to finance certain eligible pre-shipment costs in relation to export contracts that meet certain criteria established by EDC. As security for the two facilities, RBC holds a registered General Security Agreement that creates a first charge over all present and after acquired property of the Company. RBC also holds a personal guarantee from Mr. Croft.

As at the date of the Initial Order, the balance of the operating line and the revolving term loan was approximately \$300,000 and \$982,000, respectively.

With Mr. Croft providing a cash collateral to secure a portion of the operating line, RBC has allowed the continued use of the two credit facilities by the Company in accordance with the terms of the pre-existing loans.

Seaspan International Ltd. (“Seaspan”)

Hydroxyl has a term loan with Seaspan which had a balance owing of approximately \$164,000 as at the date of the Initial Order. This loan is secured by a registered General

Security Agreement that creates a second charge over all present and after acquired property of the Company (i.e. subordinated to RBC).

Business Development Bank of Canada

Hydroxyl has a \$2 million term loan with AlterinvestII Fund L.P., a limited partnership represented by its general partner, Business Development Bank of Canada (“BDC”). BDC holds a registered General Security Agreement that creates a third charge over all present and after acquired property of the Company (i.e. subordinated to RBC and Seaspan). However, BDC holds a first charge with respect to the Company’s intellectual property.

Falcon Pacific Financial Corp. (“FPFC”)

FPFC is a company owned by Mr. Croft and his wife. In addition to owning 88% of the Company’s common shares, FPFC is owed approximately \$4.76 million by the Company which is secured by General Security Agreements creating a secured charge against the Company’s assets. FPFC has subordinated its security interests to those of RBC, Seaspan and BDC.

Other Secured Creditors

Hydroxyl has various other secured creditors who hold specific security over certain assets leased by the Company (i.e. office equipment, computers, motor vehicles, etc.).

Other Liabilities

Contingent Liabilities

Kan-Pak

As previously mentioned, Kan-Pak has a counter claim against the Company for approximately \$2.5 million.

As at the Filing Date, arbitration proceedings had commenced between Kan-Pac and the Company but had not yet been completed.

BDC

Pursuant to the terms of its loan agreement, BDC is entitled to be paid a bonus that is calculated in accordance with a formula set out in the agreement upon the happening of certain triggering events including an event of default. The potential bonus could be approximately \$800,000.

Statutory Creditors

The Company is currently paying all of its statutory obligations in the normal course of business as they become due. The outstanding obligations to statutory creditors that were payable but not yet due on the Filing Date are estimated as follows:

Payroll Remittance for December 5, 2008 payroll	\$ 20,000
Workers Compensation Board	\$ 1,000

Employees

The employees continue to be paid in the ordinary course of business. As at the Filing Date, the Company's outstanding accrued vacation pay totaled approximately \$42,600 and the estimated statutory severance pay liability was approximately \$35,500.

Accounts Payable and Accrued Liabilities

As at the Filing Date, the Company's accounts payable and accrued liabilities totaled approximately \$2 million, represented by over 130 trade creditors.

POST FILING OPERATIONS

Continuity of Service

The Initial Order has provisions to facilitate the continuation of the Company's operations on a go forward basis. The Initial Order includes a provision requiring that all suppliers, contractors and other parties providing product or services to Hydroxyl continue to provide supplies or services as long as the Company makes arrangements to pay on a COD basis or other terms acceptable to the provider for the post filing obligations.

The Company has retained the contract services of Summit to assist it with restructuring its operations and develop a go forward plan.

Since the Filing Date, the Company has been able to continue its business with minimal disruption. This has been largely due to the Company's pro-active approach in dealing with its creditors, customers and other various stakeholders. The efforts made by the Company to ensure continuity of business have included the following:

- Issuance of a letter to all creditors (sent with the Monitor's package) advising them of the Company's situation and the reasons for the CCAA filing;
- Meeting with all employees immediately after the Filing Date to explain the CCAA process;

- Contacting major customers to advise of the CCAA proceedings and to confirm that business would carry on as usual and all post-filing obligations would be satisfied; and
- Contacting major trade creditors to explain the proceedings and establish acceptable arrangements to deal with post-filing obligations.

In addition to the Company's efforts, the Monitor has also been actively involved in explaining the CCAA process to many of the Company's customers and creditors.

Actual Cash Flows for December 2008

We enclose as Appendix "B" a comparison between actual and projected cash flow for the three weeks ended December 28, 2008. The actual ending cash balance was negative \$328,000 (RBC operating line is authorized at \$500,000) versus a budgeted ending cash balance of negative \$345,000.

Following are explanations provided by the Company for the variances:

Inflows

- Actual cash inflows for the period were \$191,000 versus budgeted inflows of \$260,000. The variance represents a timing difference on a \$55,000 receivable due from Island Farms.

Outflows

- Actual disbursements for the three weeks were \$220,000 versus budgeted disbursements of \$295,000;

- Actual supplier payments of \$18,000 were budgeted for under miscellaneous disbursements; and
- Payments to contract employees were below budget but were paid one week earlier in each case.

Projected Cash Flows December 29, 2008 to February 27, 2009

We enclose as Appendix “C” the Company’s cash flow projections for the period from December 29, 2008, to February 27, 2009. The projection was prepared by the Company with the assistance of Summit and the Monitor. The assumptions to the projections are also enclosed as part of Appendix “C”. In the Monitor’s opinion, the assumptions are reasonable.

Inflows

- The actual cash inflows for the period include a new contract deposit (“Letter Kenny”) of \$153,100 and these funds will in part, be used for general operations. The Company has advised however, that it intends to use the majority of these funds to begin work required by the contract.

Outflows

- The original cash flow (attached as a Schedule to Appendix “B”) showed supplier payments totaling \$238,000 for the eight weeks ending February 20, 2009. The revised cash flow shows supplier payments totaling \$657,000 of which \$500,000 relates to the two Aker contracts;
- RBC’s two loans will be paid in full once the Aker receivable of \$1.9 million is received at the end of January 2009. However, the Company projects its operating line to be approximately \$208,000 by February 27, 2009; and

- The Company projects to spend approximately \$49,000 on implementing a new sales and marketing plan.

Management

Effective December 8, 2008, Mr. Thomas Major, the Company's former Chief Operating Officer, assumed the role of acting Chief Executive Officer. The Company's former Chief Financial Officer chose not to return after the Filing Date and the Company's CEO (who was on holiday as at the Filing Date) was terminated.

Mr. Major has been with Hydroxyl for the past two years and prior to that, he has worked in senior management positions with small and large companies. Mr. Major holds a masters degree and an engineering degree.

Since assuming the role of CEO, Mr. Major has met with the Company's employees and has been instrumental in initiating discussions with the Company's creditors and customers to keep them apprised of the CCAA proceedings and the Company's situation.

RESTRUCTURING OPTIONS

The Monitor has participated in initial restructuring discussions with the Company that included the following:

- Revamping the existing share structure so that a significant equity position could be offered to potential investors;
- RBC would be paid in full from the Aker proceeds or be treated as an unaffected creditor if it remains as the operating lender to the Company;

- Seaspan, BDC and FPFC would convert some or all of their debt to equity;
- Offering a nominal cash payment and a subordinated equity position to the unsecured creditors;
- Existing shareholders will have their existing rights extinguished; and
- Aggressively pursuing new contract revenue, particularly in the industrial market.

THE INITIAL ORDER & RECOMMENDATIONS

The Monitor has had numerous discussions with creditors and other stakeholders, assisting the Company in updating its financial information, assisting the Company in preparing financial projections and participating in strategic discussions with management regarding ongoing operations and the preliminary plan of arrangement.

Based on our dealings thus far, it is our view that:

- the Initial Order has been effective in allowing the Company to move forward and focus on its restructuring and ongoing operations;
- most creditors and stakeholders are complying with the terms of the Initial Order and continuing to deal with the Company on acceptable terms;
- based on the cash flow projections (Appendix “C”), the Company should be able to sustain operations over the near term assuming operational levels are maintained at or near projected levels;

- RBC, with Mr. Croft's personal guarantee and cash collateral, has agreed to maintain a \$500,000 operating line with the Company;
- if the Company were to cease operating, the Aker and RCCL receivables would likely become uncollectible;
- the Company currently does not have sufficient contracts to maintain profitability and needs to generate new contract revenue as quickly as possible;
- BDC's continued support is critical to the future viability of the Company and its ability to file a plan of arrangement. BDC's security over the Company's intellectual property would likely be enhanced with continued operations; and
- no creditor would be materially prejudiced if an extension of time is granted to allow Hydroxyl to prepare a plan of arrangement; and

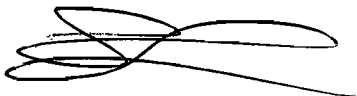
It is the Monitor's opinion that the Company is acting in good faith and with due diligence and has been cooperative in providing the Monitor with information requested.

Given operations to date, the Monitor is believes that the Company is now in a position to prepare meaningful long-term projections, continue its negotiations with BDC, continue seeking equity investors and begin developing a plan of arrangement. For these reasons, it is the Monitor's view that an extension of 30 days is required.

Dated at Vancouver, British Columbia, this 2nd day of January, 2009.

CAMPBELL, SAUNDERS LTD.

Monitor



Per: Steve Lum, CGA, CIRP

APPENDIX A

Date: 12/23/2008

Hydroxyl Systems Inc.
Balance sheet
As of November 30, 2008

	<u>YTD 2008</u>	<u>December 2007</u>
ASSETS		
Current assets:		
Cash	-\$ 88,168	\$ 998,809
Receivables	\$ 3,823,095	\$ 3,646,875
Unbilled progress payments	\$ 1,033,646	\$ 567,258
Work in progress	\$ -	\$ -
Inventory	\$ 195,962	\$ 150,470
Prepaid expenses	\$ 37,457	\$ 59,163
Deferred expenses	\$ -	\$ -
Other receivables	\$ -	\$ 35,000
Total current assets	<u>\$ 5,001,992</u>	<u>\$ 5,457,575</u>
Property and equipment	\$ 361,463	\$ 371,412
Deferred engineering and certification costs	\$ 14,248	\$ 96,648
	<u>\$ 5,377,703</u>	<u>\$ 5,925,634</u>
	\$ 5,377,703	\$ 5,925,634
LIABILITY AND SHAREHOLDER'S EQUITY		
Current liabilities:		
Trade payables	\$ 1,927,971	\$ 1,194,877
Other accrued liabilities	\$ 299,043	\$ 675,960
Deferred revenue	\$ 939,612	\$ 1,207,338
Current portion of Seaspan liabilities	\$ 82,314	\$ 326,421
Current portion of MCAP liabilities	\$ 9,275	\$ 9,275
Current portion of Royal Bank liabilities	\$ 1,171,026	\$ 1,958,608
Total current liabilities	<u>\$ 4,429,241</u>	<u>\$ 5,372,479</u>
Long term liabilities (long term portions):		
Loan Falcon Pacific	\$ 4,780,080	\$ 4,581,328.30
Capital Lease - MCAP	\$ 7,775	\$ 7,775
Loan - BDC/Altervest II	\$ 2,000,000	\$ -
Total long term liabilities	<u>\$ 6,787,855</u>	<u>\$ 4,589,103</u>
Shareholder's equity:		
Class A common shares	\$ 25,705,249	\$ 25,705,249
Contributed surplus	\$ 517,031	\$ 517,031
Retained earnings	-\$ 30,258,228	-\$ 24,260,868
Profit (loss) for year	-\$ 1,803,445	-\$ 5,997,360
Total shareholder's equity	<u>-\$ 5,839,394</u>	<u>-\$ 4,035,948</u>
	<u>\$ 5,377,703</u>	<u>\$ 5,925,634</u>
	\$ 5,377,703	\$ 5,925,634
Current ratio (ignore deferred revenue)	1.42	1.30
Debt / Net tangible assets	6.76	6.28
Debt / Net tangible assets (excluding debt subordinate to RBC) [but note: RBC debt underwritten by EDC by 75%]	0.54	N/A

HYDROXYL

APPENDIX B

HYDROXYL SYSTEMS INC.
CASH FLOW SUMMARY

	BUDGET Week 1 Dec 8/08 (\$000's)	BUDGET Week 2 Dec 15/08 (\$000's)	ACTUAL Week 2 Dec 15/08 (\$000's)	BUDGET Week 3 Dec 22/08 (\$000's)	ACTUAL Week 3 Dec 22/08 (\$000's)	BUDGET Week 4 Dec 29/08 (\$000's)	ACTUAL Week 4 Dec 29/08 (\$000's)	Week 5 Jan 5/09 (\$000's)	Week 6 Jan 12/09 (\$000's)	Week 7 Jan 19/09 (\$000's)	Week 8 Jan 26/09 (\$000's)	Week 9 Feb 2/09 (\$000's)	Week 10 Feb 9/09 (\$000's)	Week 11 Feb 16/09 (\$000's)	Total (\$000's)
Beginning Cash Balance	310	300	224	285	291	345	328	466	215	349	2,756	2,635	2,569	2,468	-
Receipts															
Other															
RCCL								170							170
BC Fairies		65													65
EDC Draw		55													110
Aker Yards															0
Island Farms															0
RCCL - Serv & Spares		140						147		60					347
CRA - SRED Claim															0
Letter Kenny															0
Aker Yards - Genesis II															0
Total Receipts	260	178	-	-	13	-	317	317	-	3,175	-	-	-	-	3,985
Disbursements:															
Payroll:															
Employees		40	47			40		40	40	40	40	40	40	40	310
Contract Employees:															
Tech Writer, IT		4				4		4	4	4	4	4	4	4	29
Ship Service employees		20	19	3	3	19		19	19	19	19	19	19	19	127
Source Deductions		20	20	14	14	20		20	20	20	20	20	20	20	154
Rent & Utilities		20	16			20		20	20	20	20	20	20	20	95
Recurring Expenses (Gas, Leases, Insurance)		24	8	10	10	8		16	6	10	8	16	8	10	153
Supplier Payments		8	8	5	5	8		10	33	10	10	10	10	205	286
Other Miscellaneous		10	3	10	10	10		10	10	10	10	10	10	10	148
Professional Services:															
Legal Fees for CCAA		20	20	25	11					50					170
Legal Fees for Ken-Pak & Anox		15	15	15	15			25	25	25	25	25	25	25	230
Conor Pacific								15	15	15	15	15	15	15	90
Monitor Fees															0
Total Disbursements	89	103	67	60	50	121	66	134	134	70	121	66	101	225	1,608
Net Cash Flow	171	76	67	60	37	121	251	251	134	3,105	121	66	101	225	2,377
Ending Cash Balance	139	224	285	345	328	466	328	215	349	2,756	2,635	2,569	2,468	2,243	2,377

APPENDIX C

	HYDROXYL SYSTEMS INC. CASH FLOW PROJECTION												FUTURE PAYMENTS	DATE
	Jan/09				Feb/09				Mar/09					
	Week Of Dec 29-Jan 2	Week Of Jan 5-9	Week Of Jan 12-16	Week Of Jan 19-24	Week Of Jan 26-30	Week Of Feb 2-6	Week Of Feb 9-13	Week Of Feb 16-20	Week Of Feb 23-27	Week Of Mar 2-6	Week Of Mar 9-13	Week Of Mar 16-20		
All Amounts In CAD														
CASH FLOW SUMMARY														
Funds available beginning of period:														
Cash in bank	\$ 7,666.52	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Operating line of credit available	156,921.00	58,144.98	125,860.57	67,045.46	49,220.46	4,568.88	500,000.00	374,130.41	264,979.97	500,000.00	374,130.41	264,979.97	500,000.00	374,130.41
Total funds available beginning of period	164,607.52	66,144.98	125,860.57	67,045.46	49,220.46	4,568.88	500,000.00	374,130.41	264,979.97	500,000.00	374,130.41	264,979.97	500,000.00	374,130.41
Funds received:														
Accounts receivable	20,678.04	13,987.79	85,000.00	-	190,866.93	1,914,305.40	-	-	50,000.00	-	-	-	50,000.00	-
New projects	-	153,125.00	-	-	-	1,914,305.40	-	-	153,125.00	-	-	-	153,125.00	-
Total funds received	20,678.04	13,987.79	85,000.00	-	190,866.93	1,914,305.40	-	-	50,000.00	-	-	-	50,000.00	-
Funds dispersed:														
Operating expenses	86,310.30	27,407.20	66,027.70	17,825.00	104,574.02	42,860.80	98,254.01	17,025.00	97,782.77	42,860.80	98,254.01	17,025.00	97,782.77	42,860.80
Payments to suppliers	34,580.28	-	57,777.41	-	105,944.49	326,573.79	40,055.28	92,125.44	67,912.54	326,573.79	40,055.28	92,125.44	67,912.54	326,573.79
Other payments	6,250.00	32,000.00	-	-	-	992,000.00	-	-	-	992,000.00	-	-	-	-
Advisor fees	-	40,000.00	-	-	25,000.00	-	-	-	10,000.00	-	-	-	-	-
Total funds dispersed	127,140.66	99,407.20	143,805.11	17,825.00	236,518.51	1,381,434.59	163,309.29	109,150.44	176,695.31	1,381,434.59	163,309.29	109,150.44	176,695.31	163,309.29
Increase (decrease) in funds	(106,462.55)	67,705.60	(58,805.11)	(17,825.00)	(44,651.59)	532,870.82	(163,309.29)	(109,150.44)	27,429.69	(163,309.29)	(109,150.44)	27,429.69	(163,309.29)	27,429.69
Funds available end of period:														
Cash in bank	-	67,705.60	-	-	-	532,870.82	-	-	27,429.69	-	-	-	27,429.69	-
Operating line of credit available	58,144.98	58,144.98	67,045.46	49,220.46	4,568.88	4,568.88	374,130.41	264,979.97	264,979.97	374,130.41	264,979.97	264,979.97	264,979.97	264,979.97
Total funds available end of period	58,144.98	125,850.57	67,045.46	49,220.46	4,568.88	537,439.70	374,130.41	264,979.97	292,409.66	537,439.70	374,130.41	264,979.97	292,409.66	292,409.66
Operating line of credit before cash in bank account	441,855.02	441,855.02	432,954.54	450,779.54	495,431.12	495,431.12	125,869.80	235,020.04	235,020.04	125,869.80	235,020.04	235,020.04	235,020.04	125,869.80
Less: cash in bank account	-	67,705.60	-	-	-	532,870.82	-	-	27,429.69	-	-	-	27,429.69	-
Remaining cash in bank account	-	-	-	-	-	37,439.69	-	-	-	-	-	-	-	-
OPERATING LINE OF CREDIT	\$ 441,855.02	\$ 374,149.43	\$ 432,954.54	\$ 450,779.54	\$ 495,431.12	\$ 495,431.12	\$ 125,869.80	\$ 235,020.04	\$ 207,590.35	\$ 125,869.80	\$ 235,020.04	\$ 207,590.35	\$ 207,590.35	\$ 125,869.80
OPERATING LINE OF CREDIT - PROJECTED DEC 8	466,000.00	215,000.00	349,000.00	-	-	-	-	-	-	-	-	-	-	-
REDUCTION (INCREASE) IN OPERATING LINE FROM DEC 8 TH	24,144.98	(159,149.43)	(83,954.54)	(450,779.54)	(495,431.12)	(495,431.12)	(125,869.80)	(235,020.04)	(207,590.35)	(125,869.80)	(235,020.04)	(207,590.35)	(207,590.35)	(125,869.80)
CASH FLOW DETAIL														
Accounts Receivable														
STX Finland - Aker						1,914,305.40								
BC Ferries - Service - All	19,054.85	13,987.79												
Catalyst Paper	560.00													
Agropur			40,000.00											
Landrau Associales	\$ 1,063.18													
RCCL - Maintenance/Media Tsir			27,684.64											
RCCL - Damage Claim			36,182.29											
RCCL - Contract			125,000.00											
RCCL - Labour														
United Oil			45,000.00											
Total Accounts Receivable	\$ 20,678.04	\$ 13,987.79	\$ 85,000.00	\$ -	\$ 190,866.93	\$ 1,914,305.40	\$ -	\$ -	\$ 50,000.00	\$ -	\$ -	\$ -	\$ 50,000.00	\$ -
New Projects - Deposits and Payments														
Letter Kenny		153,125.00											153,125.00	
Total New Projects	\$ -	\$ 153,125.00	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 153,125.00	\$ -
Potential Projects (Not Included in Funds Received)														
Inland Empire Paper (IEP) - projected														1,346,400.00
Total Potential Projects	\$ -	\$ -	\$ -	\$ 187,000.00	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,346,400.00

	Jan/09					Feb/09				NOTES	FUTURE PAYMENTS	DATE
	Week Of	Week Of	Week Of	Week Of	Week Of	Week Of	Week Of	Week Of	Week Of			
	Dec 29-Jan 2	Jan 5-9	Jan 12-16	Jan 19-24	Jan 26-30	Feb 2-6	Feb 9-13	Feb 16-20	Feb 23-27			
Operating Expenses												
Ship Contractors	22,908.55		24,000.00		24,000.00		24,000.00		24,000.00		5	
Debt Computer Leases - PAP												
Furniture Leases - PAP												
Property Insurance - PAP				9,000.00				9,000.00				
EDC AR Insurance												
Rent - Basilion		13,658.72										
Rent - Sidrely		1,297.44										
Payroll - Net Incl. Staff Expenses	37,705.26		39,730.26		43,695.26		45,454.01		45,454.01		6	
Payroll Taxes	19,446.99		20,000.00		20,000.00		20,000.00		20,000.00			
Loan Interest - RBC												
Bank Activity Fees - CAD		1,500.00										
Bank Activity Fees - USD		125.00										
D. Turner - Rent - USD		625.00										
D. Turner - Auto Leases - USD		593.75										
D. Turner - Medical - USD		1,729.73										
D. Turner - Payroll - USD												
TD\$ account												
Bank Charges - US Payroll	250.00				250.00				250.00			
Toopie Technology - IT Maintenance	500.00				3,500.00				3,500.00			
BDC Loan Interest - PAP				25.00								
IslandNet - PAP												
Shell Oil - PAP												
Sales & Marketing expenses												
Mastcare Janitorial Service	601.74		1,000.00		12,100.00	4,200.00	8,800.00	1,000.00	3,200.00		7	
Shred-It Shredding Service	67.72				381.04				361.04			
Brown Bros. Leasing - Service Van	783.61				67.72				67.72			
Ford Motor Credit - Service Van	739.68											
Parking - 2 Stalls	472.50											
Life Insurance - C. Rogers (fb cancelled)												
Bell - Cell Phones												
Telus - Land Lines & Switchboard		1,000.00			450.00				450.00			
Navigata - Long Distance		175.00										
GWL & RBC - Group Insurance		6,000.00										
Van Houite - Coffee Supplies	300.00											
Co. Expenses - RBC Visa Cards	4,894.43				150.00				500.00			
Total Operating Expenses	\$ 86,310.30	\$ 27,407.20	\$ 86,027.70	\$ 17,825.00	\$ 104,574.02	\$ 42,860.80	\$ 98,264.01	\$ 17,025.00	\$ 97,782.77			
Supplier Payments												
Steelmaster												
Smith Cameron												
TurnKey Controls	10,000.00		10,000.00		30,956.00				35,975.38		8	
Johnson Screens												
Fillirona	24,560.29		39,127.82		30,098.32		28,593.40				8	
Environmental Dynamics			8,649.59						31,937.16		8	
Concord Screens												
Endress & Hauser					2,483.31							
European Engineering												
Keaser					32,406.86				92,125.44		8	
Other supplier												
Total Supplier Payments	\$ 34,560.29	\$ -	\$ 57,777.41	\$ -	\$ 105,944.49	\$ 326,573.79	\$ 40,055.28	\$ 92,125.44	\$ 67,912.54			
Other Payments												
Royal Bank Construction Loan payments												
Legal fees for contract disputes	6,250.00								982,000.00		9	
Total Other Payments	6,250.00	32,000.00	-	-	25,000.00	20,000.00	25,000.00	-	10,000.00		10	
Advisor Fees												
Legal Fees Scott Turner		10,000.00			10,000.00				10,000.00			
Summit Group Consulting		15,000.00			15,000.00				15,000.00			
Monitor Fees		15,000.00			15,000.00				15,000.00			
Total Advisor Fees	\$ -	\$ 40,000.00	\$ -	\$ -	\$ 25,000.00	\$ 20,000.00	\$ 25,000.00	\$ -	\$ 10,000.00			
Funds increased (decreased) during period	\$ (106,462.55)	\$ 67,705.60	\$ (56,805.11)	\$ (17,825.00)	\$ (44,851.69)	\$ 532,870.82	\$ (163,309.29)	\$ (109,150.44)	\$ 27,428.69			

**HYDROXYL SYSTEMS INC.
NOTES TO CASH FLOW PROJECTION**

NOTE #	PROJECTION LINE ITEM	NOTE
1	Account receivable - STX Aker	<p>The Aker (STX) contract for Genesis 1 & 2 (NB-363 and NB-364) has payment terms of 5%, 85% and 10%. The immediate payment we are projecting is based on the 85% for Genesis 2. The terms of this are as follows: 85% of the value of the total contract in part delivery installments for delivery of equipment as provided in the Equipment Delivery Schedule.</p> <p>For Genesis 1, there was a verbal agreement between Aker and Hydroxyl to pay one lump sum payment of 85% when the bulk of equipment was delivered. The first cash flow projection for the Aker receivable on Genesis 2 used that same assumption giving 85% of EUR 2.3M or EUR 1.955M.</p> <p>Aker has subsequently stated that only received equipment can be invoiced. Due to this the immediate receivable has been updated to reflect equipment delivered in the first week of December. There will be another delivery in February 2009 which will generate an additional receivable in April (net 60 day terms) against the 85% term. However there are still more items to deliver, the last of which will be in March 2010.</p>
2	Account receivable - BC Ferries	These payments are for ongoing service and supply work.
3	Account receivable - Royal Caribbean Lines	These payments are for the commissioning of the on-board Hydroxyl processing systems of 4 ships in the RCCL fleet. This work is expected to be finished by June 2009.
4	New projects - Letterkenny	This is a new project for the US Military and a purchase order has been received. The \$153,125 payment is a 25% payment due upon system order with a follow up 25% payment due during the week of Feb 23rd. The entire contract is for \$490,000 US which converts to \$612,500 Cad.
5	Operating expenses - ship contractors	This bi-weekly expense is payment to 4 installation technicians who are commissioning the RCCL ships.
6	Operating expenses - payroll	Payroll has been reduced substantially. Included in this expense are engineers who are involved with the RCCL commissioning project as well as some support staff.
7	Operating expenses - sales & marketing expenses	A sales and marketing initiative has commenced targeting industrial and food processing plant installations. Sales and operations people will work in teams to target market potential customers with a view to obtaining contracts in the next year.
8	Supplier payments - Steelmaster, Smith Cameron, Turnkey Controls, Johnson Screens, Filtrona & Environmental Dynamics	These suppliers are supplying products and services relating to the RCCL Genesis projects and are required to be paid in order to receive the \$2.44 Million in revenue.
9	Other payments - Royal Bank of Canada	RBC will be repaid its \$982,000 construction loan when the STX receivable is paid.
10	Other payments - legal fees for contract disputes	There are two disputes where lawyers are involved. The first is a patent infringement suit in Finland which has been 90% resolved with an agreement between parties which allows Hydroxyl to continue selling and installing its systems. The second suit is a claim and counter claim with a company called Kan-Pak. Kan-Pak is refusing to pay claiming the system is not working properly. Hydroxyl claims it is working and has placed a lien against Kan-Pak. In order for this lien to continue, a US lawyer is required to continue working on the file.

Supplier Payment Forecast - Major Projects

Supplier		PO		Invoiced		Amount		Currency		Notes											
Dec 28-Jan 3	Jan 4-10	Jan 11-17	Jan 18-24	Jan 25-31	Feb 1-7	Feb 8-14	Feb 15-21	Feb 22-28	Mar 1-7	Mar 8-14	Mar 15-21	Mar 22-28	Mar 29-Apr 4	Apr 5-11	Apr 12-18	Apr 19-25					
Week 52	Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8	Week 9	Week 10	Week 11	Week 12	Week 13	Week 14	Week 15	Week 16					
Genosis 1 - Project Number 1012-B Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 320676 Amount: 30,950.00 Currency: CAD Smith Cameron Pump Solutions: 8,849.59 CAD DNV certified panels. Environmental Dynamics Inc.: 320692 CAD Fine Bubble membranes. European Engineering: 92,125.44 CAD Aeration grids for Bioreactors Filtrona Extrusion: TBD CAD Active Cell - 106 cubes 55,181.08		Genosis 2 - Project Number 1059-B Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 319878 Amount: 61,396.00 Currency: CAD Johnson Screens (Australia): 320520 N/A 2 Primary Screens Steel Master Oy: N/A CAD Assembled skids 238,526.20		United Industrial - Project Number 1052-B Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 320675 Amount: 90,294.96 Currency: CAD Filtrona Extrusion: 320675 CAD Active Cell - 180 cubes 30,068.32		IDI - Project Number 1038-L Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 320675 Amount: 10,622.43 Currency: CAD Filtrona Extrusion: 320675 CAD Active Cell - 32 cubes 18,652.43		NewsStream LLC - Project Number 1076-B Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 320675 Amount: 7,524.56 Currency: CAD Filtrona Extrusion: 320675 CAD Active Cell - 15 cubes 7,524.56		Aquapanel - Project Number 1037-L Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 320675 Amount: 8,527.86 Currency: CAD Filtrona Extrusion: 320675 CAD Active Cell - 17 cubes 8,527.86		LetterKony - Project Number TBD Outstanding Invoices post CCAA (delivered after December 8) Supplier: Shipments not yet delivered Purchase Order: 777 - TBD Amount: 112,240.00 Currency: CAD Environmental Dynamics: 72,063.36 CAD Media volume Filtrona Extrusion: 15,000.00 CAD Inertion Screens Kesser & Hinder: 15,176.64 CAD Inertion Screens Kesser: 7,000.00 CAD Blower and VFD control 777 - TBD CAD CPS control system 112,240.00									

Dec 28-Jan 3	Jan 4-10	Jan 11-17	Jan 18-24	Jan 25-31	Feb 1-7	Feb 8-14	Feb 15-21	Feb 22-28	Mar 1-7	Mar 8-14	Mar 15-21	Mar 22-28	Mar 29-Apr 4	Apr 5-11	Apr 12-18	Apr 19-25
Week 52	Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8	Week 9	Week 10	Week 11	Week 12	Week 13	Week 14	Week 15	Week 16
0.00	0.00	57,777.41	0.00	105,844.48	329,573.79	40,055.28	92,125.44	67,812.84	60,236.76	0.00	0.00	70,112.09	0.00	0.00	0.00	112,240.00
0.00	0.00	57,777.41	0.00	105,844.48	329,573.79	40,055.28	92,125.44	67,812.84	60,236.76	0.00	0.00	70,112.09	0.00	0.00	0.00	112,240.00

HYDROXYL SYSTEMS INC.
 CASH FLOW SUMMARY
 PREPARED DECEMBER 8, 2008

	Week 1 Dec 8/08 (\$000's)	Week 2 Dec 15/08 (\$000's)	Week 3 Dec 22/08 (\$000's)	Week 4 Dec 29/08 (\$000's)	Week 5 Jan 5/09 (\$000's)	Week 6 Jan 12/09 (\$000's)	Week 7 Jan 19/09 (\$000's)	Week 8 Jan 26/09 (\$000's)	Week 9 Feb 2/09 (\$000's)	Week 10 Feb 9 09 (\$000's)	Week 11 Feb 16/09 (\$000's)	Total (\$000's)												
Beginning Cash Balance	-	310	-	139	-	285	-	345	-	466	-	215	-	349	-	2,756	-	2,635	-	2,569	-	2,468	-	
Receipts																								
RCCL	-	-	-	-	170	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	170
BC Ferries	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	42
EDC Draw	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Aker Yards	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	65
Island Farms	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	55
RCCL - Serv & Spares	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	60
CRA - SRED Claim	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	140
Letter Kenny	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	147
Aker Yards - Genesis II	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	3,115
Total Receipts	260	-	-	-	317	-	-	-	-	317	-	-	-	3,175	-	-	-	-	-	-	-	-	-	3,794
Disbursements:																								
Payroll:																								
Employees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Contract Employees:																								
Tech Writer, IT	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Ship Service employees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Source Deductions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Rent & Utilities	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20	20
Recurring Expenses (Gas, Leases, Insurance)	24	8	10	8	16	8	10	8	8	16	8	8	8	16	8	8	8	16	8	8	8	10	10	134
Supplier Payments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other Miscellaneous	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	140
Professional Services:																								
Legal Fees for CCAA	20	20	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	25	145
Legal Fees for Kan-Pak & Anoxk	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Conor Pacific	15	25	15	15	25	15	15	15	15	25	15	15	15	15	15	15	15	15	15	15	15	15	15	75
Monitor Fees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	60
Total Disbursements	89	146	60	121	66	134	70	121	66	101	225	1,389												
Net Cash Flow	171	-	146	-	60	-	60	-	60	-	66	-	66	-	66	-	66	-	66	-	101	-	225	2,405
Ending Cash Balance	-	139	-	285	-	345	-	466	-	215	-	2,405												