

# Deepwell



## Energy Services

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### MANAGEMENT'S DISCUSSION AND ANALYSIS

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The following Management's Discussion and Analysis (MD&A) of Deepwell Energy Services Trust (the "Trust") has been prepared taking into consideration information available to August 14, 2009 and should be read in conjunction with the Trust's unaudited consolidated financial statements as at and for the three and six months ended June 30, 2009 and the audited consolidated financial statements as at and for the year ended December 31, 2008. This MD&A discusses operations and events for the three and six months ending June 30, 2009 and unless otherwise noted, references to the "second quarter of 2009 or the "quarter" in this MD&A refer to the three months ended June 30, 2009 and references to "second quarter of 2008 or 2008" refer to the three months ended June 30, 2008.

The Trust is an unincorporated investment trust governed by the laws of the Province of Alberta. The business of the Trust is conducted through its direct and indirect wholly owned subsidiaries, Deepwell Energy Services Commercial Trust, Deepwell Energy Services Ltd., and Deepwell Energy Services LP ("Deepwell LP") and through its 50 percent joint interest in Palko Energy Ltd. ("Palko"), (collectively "Deepwell"). The Trust and its subsidiaries are based in Calgary, Alberta and Palko is based in Midale, Saskatchewan, and were established to acquire and operate businesses that engage in oilfield waste management services. The principal undertaking of Deepwell is to provide a variety of upstream oilfield water disposal and waste management services to oil and natural gas exploration and production companies in western Canada.

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### Forward-looking statements

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Certain statements in this MD&A constitute "forward-looking" statements that involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Trust or Deepwell, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. When used in this MD&A, such statements use such words as "may", "will", "intend", "should", "expect", "believe", "plan", "anticipate", "estimate", "predict", "potential", "continue" or the negative of these terms or other similar terminology are intended to identify forward-looking statements. Such forward looking statements include that Deepwell's facilities, including Palko, will continue to add increased value. This statement is based on the assumptions that current activity by Palko's customers will continue and that Palko will be able to capitalize on such activity. The risks are that drilling and production activity will not continue at current levels or that Palko will not be providing the required oilfield water disposal and waste management services, associated with such activity. These statements reflect current expectations regarding future events and operating performance and speak only as of the date of this document. The Trust's ability to continue as a going concern is dependent upon its future performance in light of these risks, many of which are beyond its control. It is also dependent upon its ability to renew its financing arrangements or obtain alternative financing.

Forward-looking statements involve significant risks and uncertainties, should not be read as guarantees of future performance or results, and will not necessarily be accurate indications of whether such results will be achieved. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements.

Although the forward-looking statements contained in this document are based upon what management believes are reasonable assumptions, the Trust cannot assure investors that actual results will be consistent with these forward-looking statements. These forward-looking statements are made as of the date of this document and the Trust does not assume any obligation to update or revise any forward-looking statements used in this document to reflect new events or circumstances, except as required by applicable securities legislation.

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## **Non-GAAP measures**

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The financial information within the MD&A has been prepared in accordance with Canadian generally accepted accounting principles (GAAP). Certain supplementary information and measures not recognized under GAAP are also provided where management believes they assist the reader in understanding the Trust's results. These measures include:

- EBITDA, which refers to earnings before restructuring charges, unit-based compensation, interest & financing costs, taxes, depreciation, amortization, impairment of goodwill and taxes; and EBITDA per unit is calculated as EBITDA for the period divided by the weighted average trust units outstanding over the period; and
- Funds from operations, which refers to cash flow from operating activities before changes in non-cash working capital; and funds from operations per unit is calculated as funds from operations for the period divided by the weighted average trust units outstanding over the period.

These measures are identified and presented. Readers should be cautioned, however, that these measures should not be construed as alternatives to measures determined in accordance with GAAP as an indicator of the Trust's performance. The Trust's method of calculating these measures may differ from that of other organizations and, accordingly, may not be comparable with measures of other organizations.

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## **Strategy**

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Deepwell is committed to building value for its unitholders through disciplined management and the implementation of its long-term strategy. The core principles of Deepwell's strategy are summarized below.

- Focus on oilfield waste management: Deepwell currently operates exclusively in the upstream oilfield waste management business. The oilfield waste management business in western Canada has significant barriers to entry, which support the long-term cash flow of current and future facilities.
- Operational efficiency: A key objective is to attain and maintain efficient operations and a high standard of customer service within a safe working environment.
- Environmental stewardship: Deepwell intends to meet or exceed regulatory requirements and industry standards. Deepwell's facilities are audited annually by regulatory bodies, and voluntarily by an industry safety association, and periodically by exploration and production companies. Deepwell has developed innovations to enhance environmental stewardship at existing facilities.

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## Second quarter 2009 overview

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The second quarter of 2009 has been spent continuing to review operational efficiencies which have led to financial reductions. With the downturn in the industry, Deepwell's focus has been to review its business strategy and culture to better position it to move forward with the best alternative. Deepwell has focused on cost control and aggressively evaluating expenditure requirements. In addition, Deepwell has initiated a sales team whose mandate is not only to focus on its current customer base but also to increase this base. The potential is there to pursue specific revenue streams and become the preferred service provider.

Regulatory approvals is a key component of Deepwell's operations. By the end of June 2009, Deepwell was in compliance with the majority of the regulatory requirements for its facilities.

Revenue decreased in the second quarter of 2009 to \$2.2 million from \$4.7 million in the second quarter of 2008, primarily as a result of decreased volumes directly related to the depressed activity in the oil and gas sector, and associated lower market pricing. Since the majority of the operating expenses associated with the plants are fixed, this reduced the operating margin to 19% from 40% in the comparative quarter in 2008. Capital expenditures in the parent entity were kept to a minimum in the quarter. Expansion work continued on the Palko facility to allow Palko to service the demand in its operational area.

A loan amending agreement dated June 10, 2009 was proposed by the lender. This agreement has converted the Trust's operating loan to a demand loan and has capped the revolving term loan with additional financing up to \$1 million for non-discretionary capital items. This agreement proposes new covenants which are more in line with Deepwell's current operating position and includes the requirement to raise an additional \$5,000,000 in debt or equity. These funds are to be applied as a reduction in the revolving term loan with no associated reduction in authorization. The bank has provided notice that failure to raise this required equity capital represents a default under the agreement and a fee will be payable. Subsequent to June 30, 2009, the Trust signed a letter of intent with a third party for a proposed private placement and a strategic relationship.

### Selected financial information

The following is a summary of selected financial information that has been derived from, and should be read in conjunction with, the unaudited consolidated financial statements of the Trust

Financial Highlights	For the three months ended June 30		
	2009	2008	2007
Revenue	\$ 2,149,900	\$ 4,738,690	\$ 2,532,151
Operating expenses	1,716,230	2,852,928	1,190,739
<b>Operating Margin</b>	433,670	1,885,762	1,341,412
General and administrative expenses	474,095	688,254	558,849
<b>EBITDA</b>	\$ (40,425)	\$ 1,197,508	\$ 782,563
Per unit, basic and diluted	(0.01)	0.17	0.18
<b>Net loss</b>	\$ (1,728,610)	\$ (271,383)	\$ (624,201)
Per unit, basic and diluted	(0.24)	(0.04)	(0.14)
<b>Funds (used in) from operations</b>	\$ (350,795)	\$ 1,044,879	\$ 553,113
Per unit, basic and diluted	(0.05)	0.15	0.13
<b>Distributions to Unitholders</b>	\$ -	\$ 1,292,051	\$ 753,183
Per unit, basic and diluted	-	0.18	0.17
Capital expenditures	\$ 434,830	\$ 858,390	\$ 1,613,245
Total assets, end of period	\$ 56,650,953	\$ 62,825,170	\$ 53,839,846
Long term debt, end of period	\$ -	\$ 10,000,000	\$ 13,500,000
Total liabilities, end of period	\$ 22,264,780	\$ 14,902,020	\$ 17,526,248
Trust unit, end of period	\$ 56,386,571	\$ 56,314,060	\$ 40,443,363

<b>Financial Highlights</b>	For the three months ended June 30		
	2009	2008	2007
<b>Weighted average Trust units</b>			
Basic	7,200,198	7,180,086	4,357,724
Diluted	7,200,198	7,184,666	4,357,744

<b>Financial Highlights</b>	For the six months ended June 30		
	2009	2008	2007
Revenue	\$ 5,416,026	\$ 9,866,380	\$ 6,959,661
Operating expenses	4,029,290	5,580,583	3,109,961
<b>Operating Margin</b>	1,386,736	4,285,797	3,849,700
General and administrative expenses	1,236,640	1,165,968	1,155,393
<b>EBITDA</b>	\$ 150,096	\$ 3,119,829	\$ 2,694,307
Per unit, basic and diluted	0.02	0.43	0.62
<b>Net (loss) income</b>	\$ (2,678,363)	\$ 401,368	\$ (528,356)
Per unit, basic and diluted	(0.37)	0.06	(0.12)
<b>Funds (used in) from operations</b>	\$ (381,264)	\$ 2,857,285	\$ 2,475,808
Per unit, basic and diluted	(0.05)	0.40	0.57
<b>Distributions to Unitholders</b>	\$ -	\$ 2,582,855	\$ 1,849,153
Per unit, basic and diluted	-	0.36	0.42
Capital expenditures	\$ 1,684,987	\$ 3,770,183	\$ 2,451,930
Total assets, end of period	\$ 56,650,953	\$ 62,825,170	\$ 53,839,846
Long term debt, end of period	\$ -	\$ 10,000,000	\$ 13,500,000
Total liabilities, end of period	\$ 22,264,780	\$ 14,902,020	\$ 17,526,248
Trust unit, end of period	\$ 56,386,571	\$ 56,314,060	\$ 40,443,363
<b>Weighted average Trust units</b>			
Basic	7,200,198	7,180,086	4,356,867
Diluted	7,200,198	7,184,021	4,356,867

Included in the consolidated financial statements is Deepwell's 50 percent joint interest in Palko Energy Ltd. from the date of acquisition, which was September 25, 2008. Deepwell's proportionate share of net revenue for the three and six months ended June 30, 2009 was \$0.3 million and \$0.6 million and operating margin of \$0.1 million (23%) and \$0.2 million (42%). EBITDA was \$43,771 (11%) and \$228,758 (30%). Palko operations have not experienced the rapid decline in activity that has occurred in other parts of western Canada. There are no comparative figures for the second quarter of 2008 as the Palko joint venture was not entered into until September 2008.

Net loss for the three and six months ended June 30, 2009 was (\$0.24) and (\$0.37) per unit basic and diluted (2008 – (\$0.04) and 0.06 per unit basic and diluted) and funds (used in) from operations was (\$0.05) and (\$0.05) per unit basic and diluted (2008 – \$0.15 and \$0.40 per unit basic and diluted). There were no distributions paid to unitholders during 2009 (2008 – \$1.3 million or \$0.18 per unit and \$2.6 million or \$0.36 per unit).

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## Results of operations

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### Revenue

For the three and six months ended June 30, 2009, revenue was \$2.2 million and \$5.4 million versus \$4.7 million and \$9.9 million in the comparative periods in 2008. Revenue in the second quarter is comprised of approximately 70 percent processing and disposal fees (2008 – 60 percent), and 30 percent for the sale of recovered oil (2008 – 40 percent). In the second quarter of 2009 processing and disposal revenue decreased to \$2.3 million from \$2.9 million in the second quarter of 2008, due to reduced drilling activity as a result of the global downturn. During the second quarter of 2009, oil revenue fell to \$1.0 million from \$2.2 million in 2008 as a result of lower average oil prices and decreased volumes. Revenue decreased to \$2.3 million in the second quarter from \$3.2 million in the first quarter due to both lower volumes and prices.

### Expenses

#### *Operating expenses*

For the three and six months ended June 30, 2009, operating expenses were \$1.7 million and \$4.0 million compared to \$2.9 million and \$5.6 million in the comparative periods in 2008. During the second quarter of 2009, operating expenses decreased to \$1.7 million from \$2.3 million in the first quarter of 2009 resulting in an operating margin of 20% for the quarter compared with 29% in the first quarter of 2009 and 40 percent in the second quarter of 2008. Large decreases were experienced in fuel/chemical and landfill/waste/flush direct expenses. This is due to the composition of sales and lower solids in waste received for processing.

#### *General and administrative expenses*

For the three and six months ended June 30, 2009, general and administrative expenses were \$0.5 million and \$1.2 million versus \$0.7 million and \$1.2 million in the comparative periods in 2008. This represents 21% and 22% of revenue for 2009 versus 15% and 12% in 2008. The second quarter decreased by \$0.2 million from the first quarter of 2009 due to lower salary and consulting costs resulting from the restructuring. General and administrative expenses comprised primarily of costs associated with the Trust's corporate office, including senior management and public company costs. Decreases experienced in 2009 versus the comparative periods in 2008 are consistent with the Trust's strategy to run a leaner organization.

#### *Depreciation, amortization and accretion*

For the three and six months ended June 30, 2009, depreciation was \$1.2 million and \$2.3 million versus \$1.1 million and \$2 million for the comparative periods in 2008. The increase between 2009 and 2008 is primarily as a result of depreciation expense relating to the Claresholm and Palko facilities. Amortization of intangibles assets consists of the amortization of completions and contracts, customer relationships, and non-competition agreements that were acquired with the Producers Oilfield assets in 2006.

#### *Interest and financing costs*

For the three and six months ended June 30, 2009, interest and financing costs were \$0.3 million and \$0.5 million versus \$0.2 million and \$0.3 million for the comparative periods in 2008. This category includes interest on short term and long term borrowings and fees incurred to refinance the Trust's credit facilities with its bank. Interest and financing charges increased by \$0.1 million between the first and second quarters in 2009 due to the proposed loan amending agreement with an increase in interest rates to prime plus 4% plus fees associated with the proposed agreement.

#### *Funds from operations*

Funds from operations, defined as cash flow (used in) from operations before changes in non-cash working capital, were (\$0.4) million and (\$0.4) million in the three and six months ending June 30, 2009 versus \$1.0

million and \$2.9 million in the comparative periods in 2008. The continued decrease reflects the impact of lower oil prices, lower volumes produced, and the global down turn.

### ***Distributions to Unitholders***

No distributions were paid in 2009 versus \$1.3 million and \$2.5 million in the comparative periods in 2008. In December 2008, the Trust suspended all distributions to allow Deepwell to conserve cash, manage its debt levels and position the Trust to capitalize on future growth opportunities as the economy improves.

### ***Capital expenditures***

For the three and six months ended June 30, 2009, the capital expenditures were \$0.4 million and \$1.7 million versus \$0.9 million and \$3.8 million in the comparative periods in 2008. Capital expenditures decreased by \$0.8 million between the first and second quarters of 2009. Most of the capital expenditures in 2009 related to the re-completion of the Grande Cache disposal well at a cost of \$0.8 million, expansion of the Palko facility at a cost of \$0.7 million, and maintenance capital of \$0.2 million.

### ***Financial security deposits***

Deepwell has issued letters of guarantee in the amount of \$2.3 million (2008 - \$2.3 million) to the ERCB as security for abandonment and reclamation of oilfield waste management facilities.

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## **Unitholders' equity**

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The Trust is authorized to issue an unlimited number of Trust units which carry the right to vote. Trust units are redeemable at any time at the option of the unitholder. The redemption price is equal to the lesser of 90 percent of the average market price for the 10 days immediately prior to the date the units were tendered for redemption and the closing market price on the date the units were tendered for redemption. As at August 14, 2009 there were 7,200,198 Trust units issued and outstanding.

The Trust is authorized to issue an unlimited number of Special Voting Units, which will enable the Trust to provide voting rights to holders of any exchangeable shares that may be issued by any direct or indirect subsidiaries of the Trust. Except for the right to vote, the Special Voting Units do not confer any other rights. No Special Voting Units have been issued by the Trust.

On April 10, 2007, the Trust established a distribution reinvestment plan (the "DRIP"). The DRIP allows eligible unitholders of the Trust to direct that their cash distributions be reinvested in additional Trust units. The cash distributions will be re-invested at the discretion of Deepwell Energy Services Ltd. either by acquiring Trust units issued from treasury at 95 percent of the average market price (as defined in the DRIP) or by acquiring Trust units at prevailing market.

### **Trust unit option plan**

As at June 30, 2009, a total of 381,615 options were outstanding (2008 – 511,971), pursuant to the Trust's incentive unit option plan ("Option Plan"). The options carry a five-year term and vest equally over a period of three years from the date of grant. The exercise price of each option is based upon the weighted average trading price for a period prior to the date of grant. The exercise price is adjusted downwards by 100 percent of the amount of distributions paid on outstanding Trust units.

The fair value of unit options granted to employees and directors on or after August 22, 2006 is recognized as a compensation cost. The impact of monthly distributions and corresponding changes in exercise price during the life of the options are assumed to be equal and offsetting, and so no provision is made in the pricing model for either factor.

For the three and six months ended June 30, 2009, the Trust recognized stock based compensation expense of \$0.1 million and (\$0.2) million versus \$0.1 million and \$0.2 million in 2008. During 2009, the Trust recognized a recovery related to the impact of options that have been forfeited or cancelled.

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## **Liquidity**

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As at June 30, 2009, the Trust had a working capital deficit of \$17.6 million of which \$14.4 million is comprised of long term debt reclassified to current due to the breach of bank covenants in the first quarter (December 31, 2008 – \$15.6 million) and an accumulated deficit of \$23.1 million (December 31, 2008 – \$20.4 million). During the second quarter, the Trust received a proposed loan amending agreement from its lender. See the “Credit facilities” section for further discussion. Should the Trust be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due. The Trust's ability to continue as a going concern is dependent upon its ability to attain and maintain profitable operations and to continue to obtain financing from investors and its creditor sufficient to meet current and future obligations.

### **Credit facilities**

The renewal of the Trust's credit facilities on September 19, 2008 expired on May 28, 2009. A loan amending agreement was proposed effective June 10, 2009. This proposal includes the requirement for the Trust to raise an additional \$5 million. Failure to provide satisfactory evidence of the required equity capital represents a default and a fee is payable to the Bank should the Company fail to meet this requirement. Subsequent to June 30, 2009, the Trust signed a letter of intent with a third party for a proposed private placement and a strategic relationship. The agreement is conditional upon the Trust obtaining unitholder approval of the private placement, a rights offering being issued and regulatory approvals. Discussions are currently taking place with the Bank in regards to the private placement satisfying the bank's requirements. The terms of the existing proposed facility consist of the following:

#### ***Demand loan***

The operating loan was converted to a demand loan facility bearing interest at the lender's prime rate plus 4 percent with unused amounts subject to standby fees of 1.5%. Deepwell is subject to financial covenants of maintaining a minimum working capital ratio of 1.25:1, less than a 20% negative variance in actual to forecasted earnings before interest, income taxes, depreciation and amortization (“EBITDA”), and less than a \$1,500,000 negative variance in actual equity to forecasted equity. The Trust is in compliance with these covenants as at June 30, 2009.

#### ***Extendible revolving term loan***

The Trust has a three year extendible term loan to May 31, 2010. A payment of \$1,500,000 is required on May 31, 2010. If the loan is not extended by the bank for an additional 364 day period, the balance of the loan shall be amortized over two years and repaid in full by May 31, 2012. The facility loan authorization is limited to \$20,148,032 plus up to an additional \$1,007,000 to fund non-discretionary capital expenditures and bears interest at the lender's prime rate plus 4 percent with any unused amounts subject to standby fees. This facility must be reduced by the \$5,000,000 in additional funding to be raised.

### **Capital Resources**

The Trust has commitments of \$0.3 million for capital expenditures as at June 30, 2009.

### **Off-Balance Sheet Arrangements**

The Trust has no off-balance sheet arrangements as at June 30, 2009.

## Contractual obligations, commitments and contingencies

The following table shows future contractual obligations by period:

Payments by period	Total	2009-2010	2011-2012	Thereafter
Total contractual obligations	\$2,783,110	\$1,301,680	\$629,153	\$852,277

## Quarterly information

	2009		2008	
	Q2	Q1	Q4	Q3
Revenue	\$ 2,149,900	\$ 3,266,126	\$ 3,925,309	\$ 4,861,607
Operating expenses	1,716,230	2,313,060	2,318,004	2,856,716
Operating Margin	433,670	953,066	1,607,305	2,004,891
General and administrative	474,095	762,545	721,903	746,382
EBITDA	(40,425)	190,521	885,402	1,258,509
Net income (loss)	\$ (1,728,610)	\$ (949,753)	\$ (996,074)	\$ (7,915,951)
Net income (loss) per Trust unit:				
Basic and diluted	(\$0.24)	(\$0.13)	(\$0.14)	(\$1.10)
Weighted average number of Trust units outstanding				
Basic	7,200,198	7,200,198	7,196,858	7,188,578
Diluted	7,200,198	7,200,198	7,196,858	7,193,174

	2008		2007	
	Q2	Q1	Q4	Q3
Revenue	\$ 4,738,690	\$ 5,127,690	\$ 3,650,736	\$ 3,513,654
Operating expenses	2,852,930	2,727,653	1,941,216	1,584,125
Operating Margin	1,885,760	2,400,037	1,709,520	1,959,529
General and administrative	597,415	477,714	842,446	520,071
EBITDA	1,288,345	1,922,323	867,072	1,409,458
Net income (loss)	\$ (271,385)	\$ 672,753	\$ (245,156)	\$ 215,614
Net income (loss) per Trust unit:				
Basic and diluted	(\$0.04)	\$0.09	(\$0.03)	(\$0.03)
Weighted average number of Trust units outstanding				
Basic	7,180,086	7,173,770	7,154,344	6,324,139
Diluted	7,184,666	7,173,770	7,154,344	6,327,260

The Trust's business is seasonal with the first and fourth quarters traditionally being the two strongest quarters for the industry and the second quarter being the weakest. The underlying causes of the seasonality are variations in prevailing weather conditions, which in turn have effects on the ability to carry out field operations. While Deepwell's facilities remain open and accessible throughout the year, its

customers are, at times, restricted from moving waste due to spring breakup or periods of rainfall. In the Grande Cache region restrictions also occur at certain times of the year in designated wildlife areas.

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## **Financial instruments**

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The Trust's financial instruments include cash, accounts receivable, bank indebtedness, accounts payable and accrued liabilities, and credit facilities. The carrying values of these financial instruments approximate their fair values due to their relatively short periods to maturity.

The Trust's risk management policies are established to identify and analyze the risks faced by the Trust, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Trust's activities. The Trust has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments.

The Board of Directors has overall responsibility for the establishment and oversight of the Trust's risk management framework. The Board has implemented and monitors compliance with risk management policies as set out in note 11 to the unaudited interim consolidated financial statements as at and for the three and six months ended June 30, 2009.

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## **Capital management**

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The Trust's objective when managing capital is to maintain a flexible capital structure which will allow it to execute acquisitions and any capital expenditure programs. The Trust seeks to maintain a balance between the level of long-term debt and unitholders' equity to ensure access to capital to fund growth and working capital given the cyclical nature of the oilfield services sector.

The Trust considers its capital structure to include working capital, debt, and unitholders' equity. The Trust monitors capital based on annual funds from operations and acquisition opportunities, for which budgets are updated as necessary and are reviewed and periodically approved by the Trust's Board.

The Trust manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Trust's assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations.

The Trust has externally imposed capital requirements as governed by the credit facilities through the maintenance of certain bank covenants. As at June 30, 2009, the Trust is in compliance with its financial covenants.

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## **Outlook**

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For Deepwell, like most other companies, the first half of 2009 has continued with many industry indicators remaining negative as compared to the same period of 2008, a time in which oil prices approached record highs. The overall economy remains in a state of depressed credit and equity markets. Activity in the oil and gas sector has been reduced significantly.

Deepwell management continues to actively review the existing structure with a mandate to reduce costs, increase market share and change its culture to better position it to move forward with whatever alternative provides projected growth and value for the unit holders.

Each plant is being reviewed and analyzed for profitability and generation of returns. The Palko acquisition continues to add value and will continue to increase as growth initiatives are identified.

Now that a letter of intent has been signed with a third party for both a private placement and strategic relationship, Deepwell's focus will be the completion of a definitive agreement, obtaining both unitholder and regulatory approvals and pursuing a rights offering. The private placement will be used to reduce the credit facility and provide for additional capital that will provide Deepwell with the resources to pursue the benefits of the strategic relationship with the third party.

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### **Critical accounting estimates**

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Management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods. The most significant estimates relate to depreciation, amortization, asset retirement obligations, accretion, income taxes, valuation of accounts receivable, unit-based compensation and recoverability of goodwill and intangibles. Actual results may differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the Trust's accounting policies as disclosed in the Trust's consolidated financial statements.

In light of the current financial instability, Deepwell has reviewed the method used and calculations of critical accounting estimates and in particular the impairment and obsolescence of its fixed assets, intangible assets and goodwill and the rates at which Deepwell depreciates fixed assets. Management believes the critical accounting estimates are reasonable under the current circumstances. Management has also assessed the valuation of the Trust's accounts receivable utilizing a variety of approaches including collection history, subsequent receipts and financial stability of the customer and believes its allowance is reasonable.

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### **Risks and uncertainties**

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#### **Capital Markets**

As a result of the weakened global economic situation, Deepwell, along with all participants in the oil and gas service industries, is experiencing restricted access to capital and increased borrowing costs. The lending capacity of all financial institutions has diminished and risk premiums have increased independent of Deepwell's business and asset base. As future capital expenditures will be financed out of cash generated from operations, borrowings and possible future equity sales, Deepwell's ability to do so is dependent on, among other factors, the overall state of capital markets and investor demand for investments in the service industry and the Trust's securities in particular.

To the extent that external sources of capital become limited or unavailable or available on onerous terms, Deepwell's ability to make capital investments and maintain existing assets may be impaired, and its assets, liabilities, business, financial condition and results of operations may be materially and adversely affected as a result.

#### **Current Global Financial Conditions**

Current global financial conditions have been subject to increased volatility and numerous financial institutions have either gone into bankruptcy or have had to be rescued by government authorities. Access to public financing has been negatively impacted by both sub-prime mortgages and the liquidity crisis affecting the asset-backed commercially paper market. These factors may impact the ability of Deepwell to obtain equity or debt financing in the future and, if obtained, on favourable terms. If these increased levels of volatility and market turmoil continue, Deepwell's operations could be adversely impacted and the trading price of the Trust's Units could be adversely affected.

## **Cyclicality of the oil and natural gas industry**

The demand for oilfield services is largely dependent on the activity levels of oil and natural gas exploration and development companies. Industry conditions are influenced by numerous factors over which the Trust has no control, including: the level of oil and natural gas prices and production; expectations about future oil and natural gas prices; the cost of exploring for, producing and delivering oil and natural gas; the expected rates of declining production from maturing basins; the discovery of new oil and natural gas reserves; available pipeline and other oil and natural gas transportation capacity; weather conditions; global political stability, military actions, regulatory and economic conditions; the ability of oil and natural gas companies to raise capital; fuel conservation measures, alternative fuel requirements, increasing consumer demand for alternatives to oil and natural gas; and technological advances in fuel economy and energy generation devices.

The current financial instability has increased the uncertainty in the oil and natural gas industry, and the uncertainty in the oil and natural gas service industry in which Deepwell operates. In Alberta, the Trust operates in mature areas of oil and natural gas development and most of its services are for producing wells. In Saskatchewan, Palko is located in a developing area of oil and natural gas production that relies more on the water production from existing wells and development of new wells.

## **Oil and natural gas prices**

The revenue, cash flow and earnings of the Trust are substantially dependent upon and affected by the level of activity associated with oil and natural gas exploration and production. Both short-term and long-term trends in oil and natural gas prices affect the level of such activity. Worldwide military, political and economic events, including initiatives by the Organization of Petroleum Exporting Countries, may affect both the demand for and the supply of oil and natural gas. Weather conditions, governmental regulation, levels of consumer demand, the availability of pipeline capacity and other factors beyond Deepwell's control may also affect the supply of and demand for oil and natural gas, leading to future price volatility.

The large fluctuations in oil and natural gas prices which have occurred during this financial crisis have resulted in fluctuations in Deepwell's revenues. Future changes in oil and natural gas prices could result in increases or decreases in total revenues and volumes processed through the Trust's facilities. Prolonged financial instability could result in oil and natural gas projects being deferred or cancelled limiting new revenue streams to service providers such as Deepwell Seasonal weather.

In Canada, the level of activity in the oil and natural gas industry is influenced by seasonal weather patterns. Spring break-up during the second quarter of each year leaves many secondary roads temporarily incapable of supporting the weight of heavy equipment, which results in severe restrictions on the provision of energy services. The timing and duration of spring break-up are dependent on weather patterns and the duration of this period will have an impact on the level of business of the Trust.

## **Dependence on key personnel**

The success of the Trust will likely continue to be dependent on the Trust's ability to attract and retain key officers and operational personnel.

## **Reliance on major customers**

It is estimated that the top 10 customers of Deepwell accounted for approximately 57 percent of processing revenue for the quarter, the largest customer accounting for approximately 22 percent. Deepwell does not generally enter into long-term contracts with its customers and there can be no assurance that the current customers will continue their relationships with Deepwell. Deepwell continues to maintain a philosophy to attract and retain customers by offering superior and personal customer service.

## **Competition**

Deepwell faces competition from a variety of competitors, many with strong financial, marketing and other resources. There can be no assurance that such competitors will not substantially increase the resources devoted to the development and marketing of oilfield services that compete with those of Deepwell or that new competitors will not enter the various markets in which Deepwell is active. Deepwell monitors the competition changes and focuses on customer service to mitigate increased competition.

## **Operating risks and insurance**

The business of Deepwell will be subject to hazards inherent in the oil and natural gas industry, such as equipment defects, malfunction and failures; accidental release; natural disasters which result in fires; vehicle accidents and explosions that can cause personal injury; loss of life; suspension of operations; damage to formations; damage to facilities; business interruption; and damage to or destruction of property, equipment and the environment. These risks could expose Deepwell to substantial liability for personal injury, wrongful death, property damage, pollution, and other environmental damages. The frequency and severity of such incidents will affect operating costs, insurability and relationships with customers, employees and regulators.

Management will continue to be actively involved in the establishing policies and monitoring operations of Deepwell for quality control and safety. However, there are no assurances that Deepwell's safety procedures will always prevent such damages. Although Deepwell maintains insurance coverage that management believes to be adequate and customary in the industry, there can be no assurance that such insurance will be adequate to cover such liabilities.

## **Environmental risks**

The Canadian oil and natural gas industry is regulated by a number of federal and provincial governmental bodies and agencies under a variety of complex federal and provincial legislation that sets forth numerous prohibitions and requirements with respect to planning and approval processes related to land use, sustainable resource management, waste management, responsibility for the release of presumed hazardous materials, protection of wildlife and the environment and the health and safety of workers. Legislation provides for restrictions and prohibitions on the transport of dangerous goods and the release or emission of various substances, including substances used and produced in association with certain oil and natural gas industry operations. The legislation addresses various permits required for drilling, access road construction, camp construction, well completion, installation of surface equipment, air monitoring, surface and ground water monitoring in connection with these activities, waste management and access to remote or environmentally sensitive areas.

Deepwell is subject to a complex and increasingly stringent array of legal requirements and potential liabilities, including with respect to the ownership and management of property, the need to obtain and comply with permits and approvals, the health and safety of employees, and the handling, use, storage, disposal, intentional or accidental release, and transportation of certain substances, including hazardous materials and dangerous goods. Failure to comply with these requirements could expose Deepwell to substantial potential penalties. There can be no assurance that Deepwell will not be required, at some future date, to incur significant costs to comply with environmental laws, or that its operations, business, assets or cash flow will not be materially adversely affected by existing conditions or by the requirements or potential liability under current or future environmental laws. To mitigate this risk, Deepwell employs a regulatory agent to monitor and plan strategies to address the changing regulatory environment.

The Canadian Federal Government has announced its intention to regulate greenhouse gases ("GHG") and other air pollutants. The Government is currently developing a framework that outlines its clean air and climate change action plan. As this federal program is under development, Deepwell LP is unable to predict the total impact of the potential regulations upon its business. It is possible that Deepwell LP's customers could face increases in operating costs in order to comply with GHG emissions legislation which could affect Deepwell's operations by reducing demand for its services.

## **Credit risk**

All of the accounts receivable of Deepwell are with customers involved in the oil and natural gas industry whose revenues may be impacted by fluctuations in commodity prices. Collection of these receivables could be negatively influenced by any prolonged substantial reduction in oil and/or natural gas prices, which could have a material adverse effect on the financial results and cash flows of Deepwell. Deepwell monitors collections closely in order to mitigate this risk.

## **Access to additional financing**

Deepwell may find it necessary in the future to obtain additional debt or equity financing to support ongoing operations of Deepwell, to undertake capital expenditures or to undertake acquisitions or other business combination transactions. There can be no assurance that additional financing will be available to Deepwell when needed or on terms acceptable to Deepwell. The inability to raise financing to support ongoing operations or to fund capital expenditures or acquisitions could limit Deepwell's growth and may have a material adverse effect on the financial results and cash flows of Deepwell.

## **Leverage and restrictive covenants**

Deepwell has credit facilities which contain a number of financial covenants that require Deepwell to meet certain financial ratios and financial condition tests. Failure to comply with the obligations in the credit facilities could result in a default which, if not cured or waived, would permit acceleration of the relevant indebtedness. Since Deepwell is in default of its credit facility covenants as at reporting date, there can be no assurance that the assets of Deepwell would be able to repay in full that indebtedness, which could result in the lenders realizing on the assets of Deepwell. Although Deepwell is actively negotiating with its lender, there is no assurance that Deepwell will be able to refinance any or all of the credit facilities on acceptable terms, or on any basis.

## **Uncertainty of cash distributions**

The actual amounts of distributions paid by the Trust to the unitholders will depend upon numerous factors, including profitability of operations, debt covenants and obligations, the availability and cost of acquisitions, fluctuations in working capital, the timing and amount of capital expenditures, applicable law and other factors beyond the control of Deepwell. In order to preserve cash, the Trust has suspended distributions indefinitely and will continue to monitor the distribution situation.

## **Government regulations**

The Trust's operations are subject to a variety of Canadian federal, provincial and local laws, regulations and guidelines, including laws and regulations relating to health and safety, the protection of the environment, and taxation.

The planned changes in the structure of oil and natural gas royalties payable to the Province of Alberta, intended to commence in 2009, could impact the exploration and development activities of E&P companies and lower the demand for Deepwell's services.

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**Related-party transactions**

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During the three and six months ended June 30, 2009, the following transactions occurred:

- a) During the three and six months ended June 30, 2009, the Trust was charged \$nil and \$33,048 (2008 - \$nil) in legal fees by a firm who employs one of the directors. This individual ceased to be a director prior to March 31, 2009.
- b) During the three and six months ended June 30, 2009, the Trust provided certain assets and other services to Palko at a cost of \$1,005 and \$4,540 (2008 – nil). These amounts have been proportionately eliminated upon consolidation.
- c) During the three and six months ended June 30, 2009, the Trust paid management fees of \$82,500 and \$165,000 to two corporations who own 50% of Palko. In total, these corporations are paid a monthly management fee of \$55,000 based on a management agreement. The Trust is responsible for paying its 50% share of this management fee.
- d) During the three and six months ended June 30, 2009, the Trust was charged \$20,636 and \$28,136 for professional services by a company who is controlled by the individual acting as chief financial officer of the Company. Included in accounts payable and accrued liabilities at June 30, 2009 is \$6,932 (December 31, 2008 - nil) due to this corporation.
- e) During the three and six months ended June 30, 2009, the Trust was charged \$35,000 and \$39,516 for professional services by a corporation who is controlled by the individual acting as chief executive officer of the Company. For the three and six months ended June 30, 2009, the fees charged include \$22,500 and \$25,403 respectively for the CEO function and \$12,500 and \$14,113 for the individual performing corporate secretarial functions. Included in accounts payable and accrued liabilities at June 30, 2009 is \$12,250 (December 31, 2008 - nil) due to this corporation.

These transactions were conducted in the normal course of operations, on commercial terms established and agreed to by the parties.

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**Accounting changes and pronouncements**

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**Future Accounting Standards****International financial reporting standards (IFRS)**

In 2005, the AcSB announced that accounting standards in Canada are to converge with IFRS. The AcSB has indicated that Canadian entities will need to begin reporting under IFRS by the first quarter of 2011 with appropriate comparative data from the prior year. Under IFRS, the primary audience is capital markets and as a result, there is significantly more disclosure required, specifically for quarterly reporting. Further, while IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy which must be addressed. The Trust is currently developing a plan for adoption of IFRS.

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**Disclosure and internal controls**

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NI 52-109 is focused on 1) disclosure controls and procedures 2) internal control over financial reporting.

Under the supervision and with the participation of the Trust's management, including the CEO and CFO, the Trust engaged third party consultants to perform an evaluation of the effectiveness of the design and

operation of the Trust's disclosure controls and procedures as defined in National Instrument 52-109. The consultants assisted with the design, documentation, and testing of internal control systems, proposed improvements, and interim measures and provide general assistance in performing its evaluation. Based on that evaluation, the Trust's management, including the CEO and CFO, have concluded that the Trust's disclosure controls and procedures were designed to provide a reasonable level of assurance over disclosure of material information, and are sufficiently designed to provide reasonable assurance regarding the reliability of financial reporting and the presentation of financial statements for external purposes in accordance with GAAP, and are effective as of June 30, 2009.

During the design and operating effectiveness assessment certain material weaknesses in internal controls over financial reporting were identified, as follows:

- Management is aware that there is a lack of segregation of duties due to the small number of employees dealing with general administrative and financial matters. However, management believes that at this time the potential benefits of adding employees to clearly segregate duties do not justify the costs associated with such increase; and
- Inherent in requiring a small number of employees dealing with general administrative and financial matters, there is inadequate review and approval of complex accounting transactions. Management has engaged a third party firm to review such transactions on an ongoing basis.

The Trust believes that the weaknesses identified in its systems of internal control are mitigated through review of the Trust's financial statements by senior management, the audit committee of the board of directors, and by consulting with external experts. In addition, senior management is active in the Trust's day-to-day operations and in monitoring the Trust's financial reporting. An internal controls review was initiated on Palko during the second quarter of 2009. The same weaknesses were apparent in Palko as in the Trust and controls are being implemented to address the weaknesses.

Notwithstanding the weaknesses identified, based on the evaluation performed, the CEO and CFO concluded that the design and operation of the Trust's disclosure controls and procedures were effective as at June 30, 2009 to ensure that information required to be disclosed by the Trust in reports filed under Canadian securities laws is gathered, recorded, processed, summarized and reported within the times specified under Canadian securities laws and is accumulated and communicated to management, including the CEO and CFO, to allow timely decisions regarding required disclosure as required under Canadian securities laws. Further, based on the Trust's mitigating procedures, the CEO and the CFO have satisfied themselves that the weaknesses identified have not resulted in material errors in the financial statements. Management and the Board of Directors are committed to transparency and completeness of financial reporting and disclosure.

The existence of the identified control weakness need not be interpreted as evidence of a lack of integrity, of unsound business practices or of unacceptable risks to an entity's shareholders and related parties. It should be noted that while Deepwell's principal executive officer and principal financial officer believe that Deepwell's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that Deepwell's disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

## **ADDITIONAL INFORMATION**

Additional information relating to the Trust, including the Trust's Annual Information Form, may be found under the Trust's profile on SEDAR at [www.sedar.com](http://www.sedar.com).