Tabled by Minister of Natural Resources
2010.05.17.

# NEWFOUNDLAND AND LABRADOR HYDRO –
# A NALCOR ENERGY COMPANY

## Consolidated Financial Statements

**December 31, 2009**

newfoundland labrador
hydro
a nalcor energy company

newfoundland labrador
hydro
a nalcor energy company

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P.O. Box 12400. St. John's. NL
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April 30, 2010

Honourable Kathy Dunderdale
Minister of Natural Resources

Minister's Office (Headquarters)
7th Floor, Natural Resources Building
50 Elizabeth Avenue
P.O. Box 8700
St. John's, NL A1B 4J6

Dear Minister Dunderdale:

Pursuant to Section 33 of the Hydro Corporation Act, 2007, please find attached the audited Consolidated Financial Statements of Newfoundland and Labrador Hydro (Hydro) for the year ended December 31, 2009.

A detailed account of Hydro's activities during the year ended December 31, 2009 is included in the Nalcor Energy 2009 Business and Financial Report.

Sincerely,

John Ottenheimer

John Ottenheimer
Chair, Board of Directors

# NEWFOUNDLAND AND LABRADOR HYDRO
# CONSOLIDATED FINANCIAL STATEMENTS
# December 31, 2009

Deloitte.

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# Auditors' Report

To the Lieutenant-Governor in Council
Province of Newfoundland and Labrador

We have audited the consolidated balance sheet of Newfoundland and Labrador Hydro (the "Company") as at December 31, 2009 and the consolidated statements of income and retained earnings, comprehensive income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles. As required by The Hydro Corporation Act, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year.

Deloitte & Touche LLP

Chartered Accountants
March 9, 2010

**BOARD OF DIRECTORS**

JOHN OTTENHEIMER Q.C. (Chair)
Corporate Director

ED MARTIN
President and Chief Executive Officer
Nalcor Energy

CATHY BENNETT
Owner/Operator
Bennett Restaurants Ltd.

TOM CLIFT
Associate Dean, Academic Programs
Memorial University - Faculty of Business

KEN MARSHALL
President
Rogers Cable - Atlantic Region

GERRY SHORTALL
Chartered Accountant
Corporate Director

**OFFICERS**

JOHN OTTENHEIMER Q.C. (Chair)
Corporate Director

ED MARTIN
President and Chief Executive Officer
Nalcor Energy

MARK BRADBURY
Corporate Treasurer
Nalcor Energy

GILBERT BENNETT
Vice President
Lower Churchill Project

WAYNE CHAMBERLAIN
General Counsel and Corporate Secretary
Nalcor Energy

JIM HAYNES
Vice President Regulated Operations
Newfoundland and Labrador Hydro

PETER HICKMAN
Assistant Corporate Secretary
Nalcor Energy

ANDY MACNEILL
Vice President
Churchill Falls

JOHN MALLAM
Vice President Engineering Services
Newfoundland and Labrador Hydro

GERARD MCDONALD
Vice President Human Resources and
Organizational Effectiveness
Nalcor Energy

GLENN H. MITCHELL
Corporate Controller
Nalcor Energy

DERRICK STURGE
Vice President Finance and Chief Financial Officer
Nalcor Energy

**HEAD OFFICE**
Newfoundland and Labrador Hydro
Hydro Place. 500 Columbus Drive
P.O. Box 12400. St. John's, NL
Canada A1B 4K7

## NEWFOUNDLAND AND LABRADOR HYDRO
### CONSOLIDATED BALANCE SHEET

| *As at December 31 (millions of dollars)* | 2009 | 2008 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | 12.7 | - |
| Short-term investments | 37.4 | 14.6 |
| Accounts receivable | 85.6 | 76.6 |
| Current portion of regulatory assets (Note 4) | 4.8 | 5.0 |
| Fuel and supplies | 59.5 | 52.7 |
| Prepaid expenses | 2.2 | 1.6 |
| | 202.2 | 150.5 |
| Property, plant and equipment (Notes 3 and 19 (f)) | 1,703.1 | 1,702.4 |
| Long-term receivables (Note 5) | 24.7 | 26.7 |
| Sinking funds (Notes 8 and 14) | 179.6 | 163.9 |
| Regulatory assets (Note 4) | 69.3 | 74.6 |
| Derivative instruments | 7.0 | - |
| Reserve fund (Note 18 (c)) | 34.8 | 23.4 |
| | 2,220.7 | 2,141.5 |
| **LIABILITIES** | | |
| Current liabilities | | |
| Bank indebtedness (Note 8) | - | 1.6 |
| Accounts payable and accrued liabilities | 62.4 | 55.1 |
| Accrued interest | 28.7 | 28.7 |
| Current portion of long-term debt (Note 8) | 37.5 | 9.1 |
| Current portion of regulatory liabilities (Note 4) | 89.8 | 22.3 |
| Deferred capital contribution (Note 19 (g)) | 0.2 | 2.2 |
| Promissory notes (Note 8) | - | 163.0 |
| Due to related parties (Notes 14 and 19) | 20.9 | 2.9 |
| | 239.5 | 284.9 |
| Long-term debt (Notes 8 and 14) | 1,141.6 | 1,175.7 |
| Regulatory liabilities (Note 4) | 32.8 | 31.5 |
| Employee future benefits (Notes 10 and 19 (f)) | 52.4 | 49.9 |
| Long-term payable (Note 9) | 4.3 | 0.7 |
| Long-term related party note payable | 23.9 | - |
| | 1,494.5 | 1,542.7 |
| **SHAREHOLDER'S EQUITY** | | |
| Share capital (Note 11) | 22.5 | 22.5 |
| Contributed capital (Notes 11 and 19 (f)) | 211.8 | 111.8 |
| | 234.3 | 134.3 |
| Accumulated other comprehensive income (Notes 13 and 14) | 22.0 | 16.5 |
| Retained earnings (Note 19 (f)) | 469.9 | 448.0 |
| | 491.0 | 464.5 |
| | 726.2 | 598.8 |
| | 2,220.7 | 2,141.5 |

Commitments and contingencies (Note 18)
Subsequent events (Note 22)
*See accompanying notes*

On behalf of the Board:

John Ottenheimer
John Ottenheimer
Director

G. Shortall
Gerald Shortall
Director

## NEWFOUNDLAND AND LABRADOR HYDRO
### CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

| *Year ended December 31 (millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Revenue | | |
| Energy sales | 561.6 | 563.3 |
| Other | 4.5 | 5.6 |
| | 566.1 | 568.9 |
| Expenses | | |
| Operations and administration | 159.1 | 141.8 |
| Fuels | 155.2 | 164.8 |
| Interest (Note 15) | 83.8 | 78.8 |
| Amortization | 54.5 | 53.0 |
| Power purchased | 47.1 | 41.0 |
| Write-down of investment (Note 6) | - | 2.7 |
| | 499.7 | 482.1 |
| Net income | 66.4 | 86.8 |
| Retained earnings, beginning of year | 448.0 | 521.8 |
| Equity transfer (Note 19 (f)) | - | (160.6) |
| Dividends | 44.5 | - |
| Retained earnings, end of year | 469.9 | 448.0 |

*See accompanying notes*

## NEWFOUNDLAND AND LABRADOR HYDRO
### CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

| *Year ended December 31 (millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Net income | 66.4 | 86.8 |
| Other comprehensive income | | |
| Change in fair value of sinking fund and reserve fund investments | (0.7) | (3.0) |
| Unrealized gain on derivatives designated as cash flow hedges | 6.2 | - |
| Comprehensive income | 71.9 | 83.8 |

*See accompanying notes*

## NEWFOUNDLAND AND LABRADOR HYDRO
### CONSOLIDATED STATEMENT OF CASH FLOWS

| *Year ended December 31 (millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Cash provided by (used in) | | |
| Operating activities | | |
| Net income | 66.4 | 86.8 |
| Adjustments for items not involving cash | | |
| Amortization | 54.5 | 53.0 |
| Accretion of long-term debt | 0.4 | 0.5 |
| Loss on disposal of property, plant and equipment | 1.3 | 2.5 |
| Unrealized gain on derivative assets | (0.8) | - |
| Write-down of investments | - | 2.7 |
| | 121.8 | 145.5 |
| Changes in non-cash operating working capital balances (Note 16) | 115.2 | 31.7 |
| | 237.0 | 177.2 |
| Financing activities | | |
| (Decrease) increase in promissory notes | (163.0) | 156.0 |
| Repayment of long-term debt | (0.9) | (207.5) |
| Dividends paid to Nalcor Energy | (44.5) | - |
| Advance to Nalcor Energy (Note 19(f)) | - | (3.0) |
| (Decrease) increase in deferred capital contribution | (2.0) | 2.2 |
| Contributed capital | 100.0 | - |
| | (110.4) | (52.3) |
| Investing activities | | |
| Additions to property, plant and equipment | (57.8) | (90.1) |
| Increase in sinking funds | (22.0) | (20.8) |
| Increase in short-term investments | (22.8) | (3.1) |
| Increase in reserve fund | (11.0) | (11.3) |
| Proceeds on disposal of property, plant and equipment | 1.3 | 0.7 |
| | (112.3) | (124.6) |
| Net increase in cash | 14.3 | 0.3 |
| Cash position, beginning of year | (1.6) | (1.9) |
| Cash position, end of year | 12.7 | (1.6) |
| | | |
| Cash position is represented by | | |
| Bank indebtedness | (4.3) | (5.5) |
| Cash equivalents | 17.0 | 3.9 |
| | 12.7 | (1.6) |
| Supplementary disclosure of cash flow information | | |
| Income taxes paid | 0.2 | 0.2 |
| Interest income received | 0.4 | 0.9 |
| Interest paid | 92.8 | 101.6 |

*See accompanying notes*

## 1. SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation**

Newfoundland and Labrador Hydro (Hydro), a Nalcor Energy company, is incorporated under a special act of the Legislature of the Province of Newfoundland and Labrador (Province) as a Crown corporation and its principal activity is the development, generation and sale of electricity.

Hydro holds interests in the following subsidiaries and jointly controlled companies:

Churchill Falls (Labrador) Corporation Limited (Churchill Falls) is incorporated under the laws of Canada and owns and operates a hydroelectric generating plant and related transmission facilities situated in Labrador which has a rated capacity of 5,428 megawatts (MW) (Churchill Falls Project).

Twin Falls Power Corporation (Twin Falls) is incorporated under the laws of Canada and has developed a 225 MW hydroelectric generating plant on the Unknown River in Labrador. The plant has been inoperative since 1974.

Gull Island Power Corporation (GIPCo) is incorporated under the laws of Canada. Its objective was to develop the hydroelectric potential at Gull Island on the lower Churchill River in Labrador, and construct a direct current transmission system from Labrador to the island of Newfoundland. Lower Churchill Development Corporation (LCDC) is incorporated under the laws of Newfoundland and Labrador and was established with the objective of developing all or part of the hydroelectric potential of the lower Churchill River (lower Churchill Development). Both GIPCo and LCDC are inactive.

Hydro and its subsidiary and jointly controlled companies, other than Twin Falls, are exempt from paying income taxes under Section 149 (1) (d) of the Income Tax Act.

**Principles of Consolidation**

The Consolidated Financial Statements include the financial statements of Hydro and its subsidiary companies, GIPCo, (100% owned) and LCDC, (51% owned). Intercompany transactions and balances have been eliminated upon consolidation.

Effective June 18, 1999, Hydro, Churchill Falls and Hydro-Québec entered into a shareholders' agreement which provided, among other matters, that certain of the strategic operating, financing and investing policies of Churchill Falls be subject to approval jointly by representatives of Hydro and Hydro-Québec on the Board of Directors of Churchill Falls. Although Hydro retains its 65.8% ownership interest, the agreement changed the nature of the relationship between Hydro and Hydro-Québec, with respect to Churchill Falls, from that of majority and minority shareholders, respectively, to that of joint venturers. Accordingly, Hydro has adopted the proportionate consolidation method of accounting for its interest in Churchill Falls subsequent to the effective date of the shareholders' agreement.

A portion of Hydro's shareholding in Churchill Falls was deposited in a voting trust pursuant to an agreement with Hydro-Québec, in relation to Churchill Falls' General Mortgage Bonds. Effective February 25, 2008, the bonds were retired, removing the requirement for the shares to be held in trust.

Churchill Falls holds 33.33% of the equity share capital of Twin Falls and is a party with other shareholders in a participation agreement which gives Churchill Falls joint control of Twin Falls. This investment is accounted for by the proportionate consolidation method.

**Use of Estimates**

The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). Preparation of these Consolidated Financial Statements requires the use of estimates and assumptions that affect the amounts reported and disclosed in these statements and related notes. Key areas where management has made complex or subjective judgements include the fair value and recoverability of assets, the reported amounts of revenue and expenses, litigation, environmental and asset retirement obligations, amortization,

## 1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

### Use of Estimates (cont'd.)

property, plant, and equipment and other employee future benefits. Actual results may differ from these estimates, including changes as a result of future decisions made by the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB), and these differences could be material.

### Rates and Regulations (Excluding Sales by Subsidiaries)

Hydro's revenues from its electrical sales to most customers within the Province are subject to rate regulation by the PUB. Hydro's borrowing and capital expenditure programs are also subject to review and approval by the PUB. Rates are set through periodic general rate applications utilizing a cost of service (COS) methodology. The allowed rate of return on rate base is 7.4% (2008 - 7.4%). Hydro applies certain accounting policies that differ from enterprises that do not operate in a rate regulated environment. Generally these policies result in the deferral and amortization of costs or credits which will be recovered or refunded in future rates. In the absence of rate regulation these amounts would be included in the determination of net income in the year the amounts are incurred. The effects of rate regulation on the financial statements are more fully disclosed in Note 4.

### Cash and Cash Equivalents and Short-term Investments

Cash and cash equivalents and short-term investments consist primarily of Canadian treasury bills and bankers' acceptances. Those with original maturities at date of purchase of three months or less are classified as cash equivalents whereas those with original maturities beyond three months and less than twelve months are classified as short-term investments. The short-term investments bear interest rates of 0.26% to 1.57% (2008 – 1.58% to 3.60%) per annum. Cash and cash equivalents are measured at fair value and short-term investments are measured at amortized cost.

### Fuel and Supplies

Fuel and supplies inventories are recorded at the lower of average cost or net realizable value.

### Property, Plant and Equipment

Property, plant and equipment is recorded at cost, which comprises materials, labour, contracted services, other costs directly related to construction and an allocation of certain overhead costs. Expenditures for additions and betterments are capitalized and normal expenditures for maintenance and repairs are charged to operations. The cost of property, plant and equipment under construction is transferred to property, plant and equipment in service when construction is completed and facilities are commissioned, at which point amortization commences.

The fair value of the future expenditures required to settle legal obligations associated with the retirement of property, plant and equipment, are recognized to the extent that they are reasonably estimable. Asset retirement obligations are recorded as a liability at fair value, with a corresponding increase to property, plant and equipment. As it is expected that Hydro's assets will be used for an indefinite period, no removal date can be determined and consequently, a reasonable estimate of the fair value of any related asset retirement obligation cannot be determined at this time. If it becomes possible to estimate the fair value of the cost of removing assets that Hydro is legally required to remove, an asset retirement obligation will be recognized at that time.

Contributions in aid of construction are funds received from customers and governments toward the incurred cost of property, plant and equipment, or the fair value of assets contributed. Contributions are treated as a reduction to property, plant and equipment and the net property, plant and equipment is amortized.

**1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)**

**Property, Plant and Equipment (cont'd.)**

Hydro
Construction in progress includes the costs incurred in preliminary feasibility studies, engineering and construction of new generation, transmission and distribution facilities. Interest is charged to construction in progress at rates equivalent to the weighted average cost of capital.

Gains or losses on the disposal of property, plant and equipment are recognized in income as incurred.

Amortization is calculated on hydroelectric generating plant and on transmission plant in service on the sinking fund method using interest factors ranging from 5.25% to 15.79%. Amortization on distribution system and other plant in service is calculated on the straight-line method. These methods are designed to fully amortize the cost of the facilities, after deducting contributions in aid of construction, over their estimated service lives.

Estimated service lives of the major assets are as follows:

| | |
|---|---|
| Generation plant | |
| Hydroelectric | 50, 75 and 100 years |
| Thermal | 25 and 30 years |
| Diesel | 20 years |
| Transmission | |
| Lines | 40 and 50 years |
| Switching stations | 40 years |
| Distribution system | 30 years |
| Other | 3 to 50 years |

Hydroelectric generation plant includes the powerhouse, turbines, governors and generators, as well as water conveying and control structures, including dams, dykes, tailrace, penstock and intake structures. Thermal generation plant is comprised of the powerhouse, turbines and generators, boilers, oil storage tanks, stacks and auxiliary systems. Diesel generation plant includes the buildings, engines, generators, switchgear, fuel storage and transfer systems, dykes and liners and cooling systems.

Transmission lines include the support structures, foundations and insulators associated with lines at voltages of 230, 138 and 69 kilovolt (kV). Switching stations assets are used to step up voltages of electricity from generating to transmission and to step down voltages for distribution.

Distribution system assets include poles, transformers, insulators and conductors.

Other assets include telecontrol, computer software, buildings, vehicles, furniture, tools and equipment.

Churchill Falls
Churchill Falls uses the group amortization method for certain property, plant and equipment, other than the generation plant, transmission and terminals and service facilities.

**1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)**

**Property, Plant and Equipment (cont'd.)**

Churchill Falls (cont'd.)
Amortization is calculated on a straight-line basis over the following estimated useful lives:

| | |
|---|---|
| Hydroelectric generation plant | 67 years |
| Transmission and terminals | 67 years |
| Service facilities | 67 years |
| Other | 5 to 100 years |

Losses on other than normal retirements are charged to operations in the year incurred as adjustments to amortization expense.

**Impairment of Long-lived Assets**
Hydro reviews the carrying value of its property, plant and equipment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. An impairment loss corresponding to the amount by which the carrying value exceeds fair value is recognized, if applicable.

**Revenue Recognition**
Revenue is recognized on the accrual basis, as power deliveries are made, and includes an estimate of the value of electricity consumed by customers in the year, but billed subsequent to year-end. Sales within the Province are primarily at rates approved by the PUB. Sales to Hydro-Québec and certain major industrial customers are at rates under the terms of applicable contracts.

A power contract with Hydro-Québec (Power Contract), dated May 12, 1969, provides for the sale of substantially all the energy from the Churchill Falls Project until 2041. The Power Contract has a 40-year term to 2016 which then renews for a further term of 25 years. The rate is predetermined in the Power Contract and decreases from the existing rate of 2.5426 mills per kilowatt hour (kWh) to 2.0 mills per kWh upon renewal in 2016.

Churchill Falls receives revenues from Hydro-Québec, under a guaranteed winter availability contract (GWAC) through 2041. The GWAC provides for the sale of 682 MW of guaranteed seasonal availability to Hydro-Québec during the months of November through March in each of the remaining years until the end of the Power Contract.

The value of differences between energy delivered and the Annual Energy Base (AEB), as defined in the Power Contract, are tracked over a four-year period and then either recovered from or refunded to Hydro-Québec over the subsequent four-year period, unless the balance is less than $1.0 million in which case it is recovered or refunded immediately. These long-term receivables or long-term payables are subject to interest at 7% per annum (2008 - 7%).

**Foreign Currency Translation**
Foreign currency transactions are translated into their Canadian dollar equivalent as follows:

(a) At the transaction date, each asset, liability, revenue or expense is translated using exchange rates in effect at that date.

(b) At the date of settlement and at each balance sheet date monetary assets and liabilities are adjusted to reflect exchange rates in effect at that date. Any resulting gain or loss is reflected in income.

(c) Foreign exchange gains and losses are included in income except for unrealized gains and losses related to First Mortgage Bonds which were recoverable under the Power Contract.

## 1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

**Employee Future Benefits**

Employees participate in the Province's Public Service Pension Plan, a multi-employer defined benefit plan. The employer's contributions are expensed as incurred.

Hydro provides group life insurance and health care benefits on a cost-shared basis to retired employees, in addition to a severance payment upon retirement. The expected cost of providing these other employee future benefits is accounted for on an accrual basis and has been actuarially determined using the projected benefit method prorated on service and management's best estimate of salary escalation, retirement ages of employees and expected health care costs. The excess of net cumulative actuarial gains and losses over 10% of the accrued benefit obligation is amortized over the expected average remaining service life of the employee group, which is approximately 13 years.

**Financial Instruments and Hedging Activities**

Financial Instruments

Financial assets and financial liabilities are recognized on the balance sheet when Hydro becomes a party to the contractual provisions of the instrument and are initially measured at fair value. Subsequent measurement is based on classification. Hydro has classified each of its financial instruments into the following categories: financial assets and liabilities held for trading; loans and receivables; financial assets held to maturity; financial assets available for sale; and other financial liabilities.

Hydro has classified its financial instruments as follows:

| | |
|---|---|
| Cash and cash equivalents | Held-for-trading |
| Short-term investments | Available-for-sale |
| Accounts receivable | Loans and receivables |
| Sinking funds - investments in same Hydro issue | Held-to-maturity |
| Sinking funds - other investments | Available for sale |
| Reserve fund | Available for sale |
| Long-term receivable | Loans and receivables |
| Bank indebtedness | Other liabilities |
| Accounts payable and accrued liabilities | Other liabilities |
| Promissory notes | Other liabilities |
| Long-term debt | Other liabilities |
| Due to related parties | Other liabilities |

Each of these financial instruments is measured at amortized cost, except for the reserve fund, sinking fund – other investments, cash and cash equivalents and short-term investments which are measured at fair value.

Transaction costs related to financial assets and financial liabilities are included as part of the cost of the instrument, with the exception of cash and cash equivalents and short-term investments which are expensed as incurred, based upon the pricing obtained during the quotation process. Discounts and premiums on financial instruments are amortized to income over the life of the instrument.

Derivative Instruments and Hedging Activities

Derivative instruments are utilized by Hydro to manage market risk. Hydro's policy is not to utilize derivative instruments for speculative purposes. Hydro may choose to designate derivative instruments as hedges and apply hedge accounting if there is a high degree of correlation between price movements in the derivative instruments and the hedged items. Hydro formally documents all hedges and the risk management objectives at the inception of the hedge. Derivative instruments that have been designated and qualify for hedge accounting are classified as either cash flow or fair value hedges.

## 1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

**Financial Instruments and Hedging Activities (cont'd.)**

Derivative Instruments and Hedging Activities (cont'd.)
Hydro has designated forward foreign exchange contracts as cash flow hedges (Note 14). In a cash flow hedge relationship, the portion of gains or losses on the hedging item that is determined to be an effective hedge is recognized in Other Comprehensive Income (OCI), while the ineffective portion is recorded in net income. The amounts recognized in OCI are reclassified in net income when the hedged item affects net income.

Hydro had no fair value hedges in place at December 31, 2009 or 2008.

## 2. CHANGES IN ACCOUNTING POLICIES

**New Accounting Policies**
Effective January 1, 2009, Hydro adopted the following new accounting standards issued by the Canadian Institute of Chartered Accountants (CICA):

Goodwill and Intangible Assets
Section 3064, Goodwill and Intangible Assets establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets and provides more comprehensive guidance particularly with respect to internally developed intangible assets. This new standard did not have any impact on Hydro's financial results or disclosures.

Financial Instruments
EIC-173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities issued by the Emerging Issues Committee. This abstract requires that an entity's own credit risk (for financial liabilities) and the credit risk of the counterparty (for financial assets) should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this abstract did not have a material impact on Hydro's Consolidated Financial Statements.

Hydro also adopted the changes made by the CICA to Section 3862, Financial instruments – Disclosures whereby an entity shall classify and disclose fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy shall have the following levels:

Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices).

Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value. The required disclosures are included in Note 14.

## 2. CHANGES IN ACCOUNTING POLICIES (cont'd.)

**Future Accounting Changes**

International Financial Reporting Standards (IFRS)
In October 2009, the Accounting Standards Board (AcSB) issued a third and final Omnibus Exposure Draft confirming that publically accountable enterprises in Canada will be required to apply IFRS in full and without modification, for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. Accordingly, starting in 2011, Hydro will present its financial statements in accordance with IFRS, and will be required to present restated comparative information for its year-ended December 31, 2010 balances, and will also restate its opening balance sheet as at January 1, 2010.

Hydro is continuing to assess the financial reporting impacts of the adoption of IFRS, however, the impact of these differences on Hydro's future financial position and results of operations are not reasonably estimable or determinable at this time. Hydro does anticipate a significant increase in disclosure resulting from the adoption of IFRS and is continuing to assess the level of disclosure required as well as any system changes that may be necessary to compile and process the information.

The International Accounting Standards Board (IASB) project schedule had indicated that a final standard on rate-regulated activities would be released in the second quarter of 2010. Commentary received on the Exposure Draft, and the resulting activities now planned by the IASB, creates uncertainty as to if and when a final standard will be released. If a final standard is released, it may not be until late 2011. Accordingly, Hydro is unable to conclude on the impact, if any, of differences that will apply to accounting for rate-regulated activities under IFRS versus Canadian GAAP.

## 3. PROPERTY, PLANT AND EQUIPMENT

| *(millions of dollars)* | Plant and Equipment in Service | Contributions in aid of Construction | Accumulated Amortization | Construction in Progress | Net Book Value |
|---|---|---|---|---|---|
| | | | 2009 | | |
| Generation plant | | | | | |
| Hydroelectric | 1,397.5 | 22.9 | 352.3 | 1.1 | 1,023.4 |
| Thermal | 255.8 | 0.8 | 196.0 | 0.2 | 59.2 |
| Diesel | 64.6 | 5.9 | 33.5 | 2.8 | 28.0 |
| Transmission and distribution | 820.8 | 67.7 | 263.3 | 2.2 | 492.0 |
| Service facilities and other | 284.7 | 23.5 | 166.1 | 5.4 | 100.5 |
| | 2,823.4 | 120.8 | 1,011.2 | 11.7 | 1,703.1 |
| *(millions of dollars)* | | | 2008 | | |
| Generation plant | | | | | |
| Hydroelectric | 1,407.3 | 20.5 | 351.6 | 1.5 | 1,036.7 |
| Thermal | 247.5 | 0.8 | 190.6 | 1.9 | 58.0 |
| Diesel | 62.1 | 6.0 | 31.7 | 0.8 | 25.2 |
| Transmission and distribution | 794.5 | 60.2 | 248.2 | 4.2 | 490.3 |
| Service facilities and other | 282.7 | 32.4 | 162.2 | 4.1 | 92.2 |
| | 2,794.1 | 119.9 | 984.3 | 12.5 | 1,702.4 |

At the end of 2008, pursuant to an asset transfer agreement (the Transfer Agreement) between Hydro and Nalcor Energy (Nalcor), Hydro's parent company, $157.2 million of property, plant and equipment was transferred from Hydro to Nalcor for consideration equal to net book value (Note 19(f)).

## 4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION

| *(millions of dollars)* | 2009 | 2008 | Remaining Recovery Settlement Period (years) |
|---|---|---|---|
| Regulatory assets | | | |
| Foreign exchange losses | 68.9 | 71.1 | 32.0 |
| Deferred regulatory costs | - | 0.2 | - |
| Deferred major extraordinary repairs | 4.9 | 7.6 | 2.8 |
| Deferred study costs | 0.1 | 0.2 | 2.0 |
| Deferred wind power costs | - | 0.5 | - |
| Deferred energy conservation costs | 0.2 | - | N/A |
| Total regulatory assets | 74.1 | 79.6 | |
| Less: current portion | 4.8 | 5.0 | |
| | 69.3 | 74.6 | |
| Regulatory liabilities | | | |
| Rate stabilization plan | 122.0 | 53.2 | N/A |
| Deferred purchased power savings | 0.6 | 0.6 | 17.5 |
| Total regulatory liabilities | 122.6 | 53.8 | |
| Less: current portion | 89.8 | 22.3 | |
| | 32.8 | 31.5 | |

Regulatory assets represent future revenues associated with certain costs, incurred in current or prior periods that are expected to be recovered from customers in future periods through the rate-setting process. Regulatory liabilities represent future reductions or limitations of increases in revenues associated with amounts that are expected to be refunded to customers as a result of the rate-setting process. The risks and uncertainties related to regulatory assets and liabilities are subject to periodic assessment. When Hydro considers that the value of these regulatory assets or liabilities is no longer likely to be recovered or repaid through future rate adjustments, the carrying amount is reflected in operations. The following is a description of each of the circumstances in which rate regulation affects the accounting for a transaction or event.

**Rate Stabilization Plan and Related Long-term Receivable**

On January 1, 1986, Hydro, having received the approval of the PUB, implemented a rate stabilization plan (RSP) which primarily provides for the deferral of fuel expense variances resulting from changes in fuel prices, levels of precipitation and load. Adjustments required in retail rates to cover the amortization of the balance in the plan are implemented on July 1 of each year. Similar adjustments required in industrial rates are implemented on January 1 of each year.

Pursuant to Order No. P.U. 7 (2002-2003) and Order No. P.U. 40 (2003), RSP balances which accumulated prior to December 31, 2003, were converted to a long-term receivable bearing interest at the weighted average cost of capital to be recovered over a four-year period, which commenced in 2004. The recovery period for industrial customers ended on December 31, 2007 and for the utility customers on June 30, 2008. Any remaining balances were transferred to the current plan. Any subsequent balances accumulating in the RSP, including financing charges, are to be recovered in the following year, with the exception of hydraulic variation, which will be recovered or refunded at a rate of twenty-five percent of the outstanding balance at year-end. Additionally, a fuel rider is calculated annually based on the forecast fuel price and is added to or subtracted from the rates that would otherwise be in effect.

Hydro recognizes the RSP balances as a regulatory asset or liability based on the expectation that rates will be adjusted annually to provide for the collection from, or refund to, customers in future periods. In the absence of rate regulation, Canadian GAAP would require that the cost of fuel be recognized as an operating expense in the period in which it was consumed. In 2009, $42.3 million was recognized (2008 - $9.1 million) in the RSP and $18.3 million (2008 - $14.9 million) was recovered through rates and included in energy sales, with the corresponding cost amortized in fuels expenses.

**4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd.)**

**Foreign Exchange Losses**
Hydro incurred foreign exchange losses related to the issuance of Swiss Franc and Japanese Yen denominated debt in 1975 and 1985, respectively, which were recognized when the debt was repaid in 1997. The PUB has accepted the inclusion of realized foreign exchange losses related to long-term debt in rates charged to customers in future periods. Any such loss, net of any gain, is deferred to the time of the next rate hearing for inclusion in the new rates to be set at that time. Accordingly, these losses are recognized as a regulatory asset. In the absence of rate regulation, Canadian GAAP would require that Hydro include the losses in operating costs, in each year that the related debt was outstanding, to reflect the exchange rates in effect on each reporting date.

Commencing in 2002, the PUB ordered Hydro's deferred realized foreign exchange losses be amortized over a forty-year period. This amortization, of $2.2 million annually, is included in interest expense (Note 15).

**Deferred Regulatory Costs**
Pursuant to Order No. P.U. 8 (2007), the PUB approved the deferral and amortization of external costs associated with Hydro's 2006 General Rate Application in the amount of $0.6 million. These costs are recognized as a regulatory asset. In the absence of rate regulation, Canadian GAAP would require that Hydro include these costs in operating costs in the year incurred. In 2009, $0.2 million (2008 - $0.2 million) of amortization was recognized in operations and administration expense.

**Deferred Major Extraordinary Repairs**
In its report dated April 13, 1992, the PUB recommended that Hydro adopt a policy of deferring and amortizing the costs of major extraordinary repairs in excess of $500,000, subject to PUB approval on a case-by-case basis. In 2005, Hydro started an asbestos abatement program at the Holyrood Thermal Generating Station (HTGS). This program was carried out over a three-year period. Pursuant to Order No. P.U. 2 (2005), the PUB approved the deferral and amortization of these costs as a major extraordinary repair. Accordingly, the costs incurred in each year of the program were recognized as a regulatory asset to be amortized over the subsequent five-year period. In 2006, Hydro incurred $2.3 million in expenses to repair a boiler tube failure at the HTGS. Pursuant to Order No. P.U. 44 (2006), the PUB approved the deferral and amortization of these costs as a major extraordinary repair. Accordingly, these costs are being amortized over a five-year period. In 2007, $2.0 million of expenses related to a turbine failure were deferred as a major extraordinary repair. This amount, net of insurance proceeds, was expensed in 2008. In the absence of rate regulation, Canadian GAAP would require that Hydro expense the cost of the asbestos abatement program and the boiler tube repairs in the year incurred. In 2009, $2.7 million (2008 - $2.7 million) of amortization was recognized in operations and administration expense.

**Deferred Study Costs**
Pursuant to Order No. P.U. 14 (2004), the PUB directed Hydro to conduct an independent study of the treatment of Newfoundland Power's generation in Hydro's COS, and an independent marginal cost study, and to accumulate these costs in a deferral account to be dealt with at the next general rate application. Pursuant to Order No. P.U. 8 (2007), Hydro received approval for recovery of these costs over a three year period commencing in 2007. Accordingly, these costs have been recognized as a regulatory asset. In the absence of rate regulation, Canadian GAAP would require that Hydro include the cost of these studies in operating costs in the year incurred. In 2009 there were no additions (2008 – nil) and $0.1 million (2008 - $0.2 million) of amortization was recognized in operating and administration expense.

**Deferred Wind Power Costs**
Pursuant to Order No. P.U. 20 (2008), the PUB agreed to allow Hydro to defer $0.5 million in costs associated with connecting the wind farms at St. Lawrence and Fermeuse to the Island Interconnected Grid through Newfoundland Power's transmission system and, accordingly, these costs have been recognized as a regulatory asset. These costs were expensed in 2009. In the absence of rate regulation, Canadian GAAP would require that Hydro include these costs in operating costs in the year incurred.

## 4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd.)

**Deferred Energy Conservation Costs**
Pursuant to Order No. P.U. 8 (2007), Hydro received approval to defer costs associated with an electrical conservation program for residential, industrial, and commercial sectors and , accordingly, these costs have been recognized as a regulatory asset. In the absence of rate regulation, Canadian GAAP would require that Hydro include this program as operating costs in the year incurred. In 2009, $0.2 million (2008 – nil) was deferred.

**Deferred Purchased Power Savings**
In 1997, Hydro interconnected communities in the area of L'Anse au Clair to Red Bay to the Hydro-Québec system. In its report dated July 12, 1996, the PUB recommended that Hydro defer the benefits of a reduced initial purchased power rate, to be amortized over a 30-year period. These savings in the amount of $0.6 million (2008 - $0.6 million) are recognized as a regulatory liability. In the absence of rate regulation, Canadian GAAP would require that Hydro include the actual cost of purchased power in operating costs in the year incurred.

**Property, Plant and Equipment**
The PUB permits an allowance for funds used during construction (AFUDC), based on Hydro's weighted average cost of capital, to be included in the cost of capital assets and amortized over future periods as part of the total cost of the related asset. In 2009, Hydro's AFUDC of 7.6% was higher than its cost of debt of 7.2%, the amount capitalized higher and interest expense lower by $0.1 million than that which would have been permitted in the absence of rate regulation. In 2008, Hydro's AFUDC of 7.6% was higher than its cost of debt of 7.3%, the amount capitalized higher and interest expense lower by $0.4 million than that which would have been permitted in the absence of rate regulation (Note 15).

Hydro amortizes its hydroelectric generating assets and transmission assets using the sinking fund method, as approved by the PUB. In the absence of rate regulation, these assets would likely be amortized using the straight-line method. During 2005, Hydro engaged an independent consultant to conduct an amortization study. The scope of this study included a review of Hydro's amortization methods as well as a statistical analysis of service life estimates and calculation of appropriate amortization rates and annual and accrued amortization balances as at December 31, 2004. Based on the results of this study, management currently estimates that accumulated amortization is approximately $170.0-$180.0 million lower than it would otherwise be and annual amortization expense is $10.0-$11.0 million lower, primarily due to the use of sinking fund rather than straight-line amortization for hydroelectric and transmission assets. A more recent study indicated that the amounts could be significantly higher. An update to this study is to be completed in 2010.

## 5. LONG-TERM RECEIVABLES

Long-term receivables consist of two refundable deposits in the amount of $23.9 million (2008 - $25.4 million) associated with an application for transmission service into Québec, bearing interest at one year Guaranteed Income Certificate (GIC) rates. The remaining portion of $0.8 million (2008 – $1.3 million) is a long-term receivable from Hydro-Québec, bearing interest at 7.0%.

## 6. INVESTMENTS

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Lower Churchill Development Corporation Limited | - | - |

## 6. INVESTMENTS (cont'd.)

LCDC was incorporated in 1978 pursuant to the provisions of an agreement (Principal Agreement), between the Province and the Government of Canada. The Province and the Government of Canada own equity interests of 51% and 49% of LCDC, respectively. The Principal Agreement provides that future issues of Class A common shares shall preserve, as closely as possible, this ratio of beneficial ownership. Hydro is the designate for the Province's shareholding in LCDC.

Pursuant to the provisions of the Principal Agreement, the Province agreed to enter into an Option Agreement, dated November 24, 1978, with LCDC in respect of the GIPCo assets and the hydroelectric development rights to the lower Churchill River, (the Water Rights). In consideration of the option granted from the Province, LCDC issued 520 Class A common shares to Hydro valued at $5.2 million.

The option provided that, upon agreement to continue with the Project, LCDC would have acquired the GIPCo assets for $94.8 million ($100.0 million less the amount of $5.2 million representing the shares issued pursuant to the signing of the Option Agreement). A 10% convertible demand debenture in the amount of $94.8 million would have been issued as consideration for the GIPCo assets, and LCDC would have acquired the Water Rights from the Province with the consideration having been the issue of 3,000 Class B common shares without nominal or par value.

On November 20, 2008, LCDC was advised by the Province that it would not be extending the Option Agreement. As a consequence, LCDC's option expired on November 24, 2008, which had the effect of terminating the Option Agreement. Hydro's share of the option in the amount of $2.7 million was expensed as an asset write-down in 2008 and the liability to the Government of Canada for non-controlling interest in the amount of $2.5 million was eliminated.

Hydro holds 1,540 Class A common shares of LCDC which have a stated value of $10,000 each. 520 shares were acquired in 1979 pursuant to signing of the Option Agreement and 510 shares were acquired in each of the years 1980 and 1981, by way of capital contributions from the Province.

## 7. JOINT VENTURE

The following amounts included in the Consolidated Financial Statements represent Hydro's proportionate share of Churchill Falls' assets and liabilities at December 31, 2009, and its proportionate interest in Churchill Falls' operations for the year then ended.

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Current assets | 45.7 | 35.1 |
| Long-term assets | 374.5 | 372.8 |
| | | |
| Current liabilities | 38.8 | 10.2 |
| Long-term liabilities | 12.7 | 38.0 |
| | | |
| Revenues | 57.4 | 65.4 |
| Expenses | 50.9 | 51.6 |
| Net income | 6.5 | 13.8 |
| | | |
| Cash provided by (used in) | | |
| Operating activities | 14.6 | 31.1 |
| Financing activities | 0.9 | (15.7) |
| Investing activities | (17.4) | (18.7) |

Income tax expense in the amount of $0.2 million (2008 - $0.2 million) related to a jointly controlled subsidiary, Twin Falls has been included in expenses.

## 8. LONG-TERM DEBT

| *(millions of dollars)* | 2009 | | | 2008 | | |
|---|---|---|---|---|---|---|
| | Hydro | Churchill Falls | Total | Hydro | Churchill Falls | Total |
| Long-term debt | 1,149.8 | 29.3 | 1,179.1 | 1,154.7 | 30.1 | 1,184.8 |
| Less current portion | 8.2 | 29.3 | 37.5 | 8.3 | 0.8 | 9.1 |
| | 1,141.6 | - | 1,141.6 | 1,146.4 | 29.3 | 1,175.7 |

Details of long-term debt are as follows:

**Hydro**

| Series | Face Value | Coupon Rate % | Year of Issue | Year of Maturity | | |
|---|---|---|---|---|---|---|
| *(millions of dollars)* | | | | | 2009 | 2008 |
| V * | 125.0 | 10.50 | 1989 | 2014 | 124.5 | 124.5 |
| X * | 150.0 | 10.25 | 1992 | 2017 | 149.2 | 149.1 |
| Y * | 300.0 | 8.40 | 1996 | 2026 | 293.1 | 292.9 |
| AB * | 300.0 | 6.65 | 2001 | 2031 | 306.8 | 306.9 |
| AD * | 125.0 | 5.70 | 2003 | 2033 | 123.6 | 123.5 |
| AE | 225.0 | 4.30 | 2006 | 2016 | 223.7 | 223.5 |
| Total debentures | 1,225.0 | | | | 1,220.9 | 1,220.4 |
| Less sinking fund investments in own debentures | | | | | 71.1 | 65.9 |
| | | | | | 1,149.8 | 1,154.5 |
| Other | | | | | - | 0.2 |
| | | | | | 1,149.8 | 1,154.7 |
| Less: payments due within one year | | | | | 8.2 | 8.3 |
| | | | | | 1,141.6 | 1,146.4 |

* Sinking funds have been established for these issues.

Sinking fund investments consist of bonds, debentures, promissory notes and coupons issued by, or guaranteed by, the Government of Canada or any province of Canada, and have maturity dates ranging from 2014 to 2033. Hydro debentures, which management intends to hold to maturity, are deducted from long-term debt while all other sinking fund investments are shown separately on the balance sheet as assets. Annual contributions to the various sinking funds are as per bond indenture terms, and are structured to ensure the availability of adequate funds at the time of expected bond redemption. Effective yields range from 4.50% to 9.86% (2008 - 4.50% to 9.86%).

Promissory notes, debentures and long-term loans are unsecured and unconditionally guaranteed as to principal and interest and, where applicable, sinking fund payments, by the Province. The Province charges Hydro a guarantee fee of one percent annually on the total debt (net of sinking funds) guaranteed by the Province, outstanding as of the preceding December 31. During 2008 and 2009, the guarantee fee was waived by the Province.

Hydro uses promissory notes to fulfill its short-term funding requirements. As at December 31, 2009 there were no promissory notes outstanding (2008 – $163.0 million).

Hydro maintains a $50.0 million Canadian or US equivalent unsecured operating credit facility with its banker and at year-end there were no amounts drawn on the facility (2008 – nil). Advances may take the form of a Prime Rate advance or the issuance of a Bankers' Acceptance (BA) with interest calculated at the Prime Rate or prevailing Government BA fee. The facility also provides coverage for overdrafts on Hydro's bank accounts, with interest calculated at the Prime Rate. At year-end, Hydro had two letters of credit outstanding (Note 18(g)) reducing the availability of the credit facility by $7.5 million. In February 2010, Hydro issued 22 additional letters of credit, see Note 21.

**8. LONG-TERM DEBT (cont'd.)**

**Hydro (cont'd.)**

Required repayments of long-term debt and sinking fund requirements over the next five years will be as follows:

| *(millions of dollars)* | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Sinking fund requirements | 8.2 | 8.2 | 8.2 | 8.2 | 8.2 |
| Long-term debt repayment | - | - | - | - | 125.0 |
| | 8.2 | 8.2 | 8.2 | 8.2 | 133.2 |

**Churchill Falls**

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Bank of Nova Scotia Credit Agreement | | |
| 4.4% due December 15, 2010 | | |
| Outstanding | 29.3 | 30.1 |
| Due within one year | 29.3 | 0.8 |
| Total long-term debt | - | 29.3 |

Refinancing

On February 25, 2008 Churchill Falls completed a refinancing of the General Mortgage Bonds. The General Mortgage Bonds, bearing an interest rate of 7.5% (6.0% net of subsidies) were retired and replaced with a 4.4% fixed rate credit agreement with The Bank of Nova Scotia. Principal repayment terms of the new credit agreement are the same as those required by the General Mortgage Bonds which provided for semi-annual payments in an amount equal to 1.0% of the aggregate principal amount outstanding on January 1 preceding each payment date with a final principal payment due in 2010.

Repayment of Long-term Debt

Long-term debt repayments over the next five years are as follows:

| *(millions of dollars)* | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| | 29.3 | - | - | - | - |

Dividend Restriction

Under the terms of the long-term debt instruments, Churchill Falls may pay cash dividends only out of earnings, as defined, accumulated from September 1, 1976. A shareholders' agreement signed in June 1999 places additional restrictions on dividends based on cash flow.

Operating Credit Facility

Churchill Falls maintains a $10.0 million Canadian unsecured operating credit facility with its banker. Advances may take the form of a Prime Rate advance or the issuance of a BA with interest calculated at the Prime Rate or prevailing Government BA Fee. The facility provides coverage for overdrafts on Churchill Falls' bank accounts, with interest calculated at the Prime Rate. At year-end, Churchill Falls had a letter of credit outstanding (Note 18(g)) reducing the availability of the credit facility by $0.7 million.

**9. LONG-TERM PAYABLE**

The long-term payable to Hydro-Québec as at December 31, 2009 represents the accumulation of differences between energy delivered monthly and the AEB energy billed monthly, which will be tracked during the four-year period from September 1, 2008 to August 31, 2012. Currently, the full amount of $4.3 million (2008 – $0.7 million) is long-term. The final amount will be determined on August 31, 2012 and will be paid/collected monthly beginning September 2012 and ending August 2016.

## 10. EMPLOYEE FUTURE BENEFITS

**Pension Plan**

Employees participate in the Province's Public Service Pension Plan, a multi-employer defined benefit plan. The employer's contributions of $4.6 million (2008 - $4.6 million) are expensed as incurred.

**Other Benefits**

Additionally, Hydro provides group life insurance and healthcare benefits on a cost-shared basis to retired employees, and in certain cases, their surviving spouses, in addition to a severance payment upon retirement. In 2009, cash payments to beneficiaries for its unfunded other employee future benefits was $2.7 million (2008 - $3.0 million). An actuarial valuation was performed December 31, 2009.

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Accrued benefit obligation | | |
| Balance at beginning of year | 51.1 | 68.6 |
| Transfer to Nalcor Energy | (0.5) | (1.4) |
| Current service cost | 1.4 | 2.1 |
| Interest cost | 3.8 | 3.7 |
| Actuarial loss (gain) | 16.5 | (18.9) |
| Benefits paid | (2.7) | (3.0) |
| Balance at end of year | 69.6 | 51.1 |
| | | |
| Plan deficit | 69.6 | 51.1 |
| Unamortized actuarial loss | (17.0) | (0.5) |
| Unamortized past service cost | (0.2) | (0.2) |
| Transfer to Nalcor Energy | - | (0.5) |
| Accrued benefit liability at end of year | 52.4 | 49.9 |

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Components of benefit cost | | |
| Current service cost | 1.4 | 2.1 |
| Interest cost | 3.8 | 3.7 |
| Actuarial loss (gain) | 16.5 | (18.9) |
| | 21.7 | (13.1) |
| | | |
| Difference between actual actuarial (gain) loss and amount recognized | (16.5) | 20.0 |
| Benefit expense | 5.2 | 6.9 |

The significant actuarial assumptions used in measuring the accrued benefit obligations and benefit expense are as follows:

| | 2009 | 2008 |
|---|---|---|
| Discount rate – benefit cost | 7.5% | 5.5% |
| Discount rate – accrued benefit obligations | 6.5% | 7.5% |
| Rate of compensation increase | 3.5% | 3.5% |

Assumed healthcare trend rates:

| | 2009 | 2008 |
|---|---|---|
| Initial healthcare expense trend rate | 7.5% | 7.0% |
| Cost trend decline to | 5.0% | 5.0% |
| Year that rate reaches the rate it is assumed to remain at | 2014 | 2011 |

## 10. EMPLOYEE FUTURE BENEFITS (cont'd.)

**Other Benefits (cont'd.)**
A 1% change in assumed healthcare trend rates would have had the following effects:

| *Increase* | 2009 | 2008 |
|---|---|---|
| Current service and interest cost | 0.8 | 1.2 |
| Accrued benefits obligation | 10.7 | 6.9 |

| *Decrease* | 2009 | 2008 |
|---|---|---|
| Current service and interest cost | (0.6) | (0.8) |
| Accrued benefits obligation | (8.4) | (5.5) |

## 11. SHAREHOLDER'S EQUITY

**Share Capital**

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Common shares of par value $1 each | | |
| Authorized 25,000,000 shares; | | |
| Issued and outstanding 22,503,942 shares | 22.5 | 22.5 |

**Contributed Capital**

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Total contributed capital | 211.8 | 111.8 |

During 2009, Nalcor contributed capital of $100.0 million (2008 – nil).

## 12. CAPITAL MANAGEMENT

**Hydro**
Hydro's primary objectives when managing capital are to minimize Hydro's cost of capital within the confines of established risk parameters, and to safeguard Hydro's ability to continue as a going concern. Hydro requires access to capital due to the capital intensive nature of the business which is required to ensure the continued delivery of safe and reliable service to its customers .

The capital managed by Hydro is comprised of debt (long-term debentures, promissory notes, bank credit facilities and bank indebtedness) and equity (share capital, contributed capital, accumulated other comprehensive income and retained earnings).

Hydro's approach to capital management encompasses various factors including monitoring the percentage of floating rate debt in the total debt portfolio, the weighted average term to maturity of its overall debt portfolio, its percentage of debt to debt plus equity and its earnings before interest and taxes (EBIT) coverage of interest. Adjustments to the capital structure are accomplished through adjustments to the amount of dividends paid to the Shareholder, cash infusion via contributed equity and new debt issuance or debt issuance with differing characteristics. Hydro's goal is to achieve a capital structure and cash flow to support debt.

## 12. CAPITAL MANAGEMENT (cont'd.)

### Hydro (cont'd.)

A summary of the capital structure is outlined below:

| *(millions of dollars)* | 2009 | | 2008 | |
|---|---|---|---|---|
| **Debt** | | | | |
| Bank Indebtedness | - | | 1.6 | |
| Long-term debt | 1,141.6 | | 1,175.7 | |
| Current portion of long-term debt | 37.5 | | 9.1 | |
| Promissory notes | - | | 163.0 | |
| Sinking funds | (179.6) | | (163.9) | |
| | 999.5 | 57.9% | 1,185.5 | 66.4% |
| **Equity** | | | | |
| Share capital | 22.5 | | 22.5 | |
| Contributed capital | 211.8 | | 111.8 | |
| Accumulated other comprehensive income | 22.0 | | 16.5 | |
| Retained earnings | 469.9 | | 448.0 | |
| | 726.2 | 42.1% | 598.8 | 33.6% |
| **Total debt and equity** | 1,725.7 | 100.0% | 1,784.3 | 100.0% |

### Churchill Falls

Churchill Falls' objective when managing capital is to maintain its ability to continue as a going concern. Churchill Falls' requirements for capital in the future are expected to increase, coincident with the aging of the plant and related infrastructure. The focus of the capital management policy is to provide flexibility to ensure cash continues to be available to satisfy capital requirements. Managing the level of dividend payments is a key aspect of ensuring the availability of funding to maintain the plant and infrastructure.

At present, the capital position of Churchill Falls is weighted heavily toward equity capital (share capital and retained earnings). The only remaining long-term debt at the end of the year consisted of a loan from the Bank of Nova Scotia, the balance of which comprised less than 10% of Churchill Falls' capital structure. This loan carries the same terms of repayment as the former General Mortgage Bonds and will mature in December of 2010, with any remaining principal due at that time. Churchill Falls has the right to prepay under certain conditions and has already taken advantage of the opportunity to do so. On March 19, 2008, Churchill Falls exercised its prepayment rights under the Credit Agreement to prepay $10.0 million in principal effective March 25, 2008. The corporate strategy is to ensure that funding is in place to extinguish the entire debt by the end of 2010 without re-financing. The capital structure is adjusted through the amount of dividends paid to shareholders.

## 13. ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in the fair value of sinking fund and reserve fund investments comprise the items in other comprehensive income.

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Balance, beginning of year | 16.5 | 19.5 |
| Change in fair value of sinking fund investments | (1.1) | (3.6) |
| Change in fair value of reserve fund investments | 0.4 | 0.6 |
| Unrealized gains on derivatives designated as cash flow hedges | 6.2 | - |
| Balance, end of year | 22.0 | 16.5 |

## 14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

**Fair Value**

The estimated fair values of financial instruments as at December 31 are based on relevant market prices and information available at the time. The fair value of long-term debt is estimated based on the quoted market price for the same or similar debt instruments. The fair value estimates below are not necessarily indicative of the amounts that Hydro might receive or incur in actual market transactions. As a significant number of Hydro's assets and liabilities, including fuels and supplies and property, plant and equipment, do not meet the definition of financial instruments, the fair value estimates below do not reflect the fair value of Hydro as a whole.

| | Carrying Value | Fair Value | Carrying Value | Fair Value |
|---|---|---|---|---|
| *(millions of dollars)* | 2009 | | 2008 | |
| Financial liabilities | | | | |
| Long-term debt including amount due within one year | 1,179.1 | 1,471.0 | 1,184.8 | 1,484.8 |

*Establishing Fair Value*

The fair value of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities and due to related parties approximates their carrying values due to their short-term maturity.

The fair value of long-term debt, long-term receivables, and long-term payables are determined using the present value of future cash flows under current financing agreements, based on Hydro's current estimated borrowing rate for loans with similar terms and conditions.

*Fair Value Hierarchy*

Financial instruments recorded at fair value are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices).

Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

Financial instruments included in Level 1 are cash and cash equivalents and short-term investments. Financial instruments included in Level 2 are the derivative instruments, the reserve fund and sinking funds – other investments. There are no financial instruments in Level 3.

**Risk Management**

Exposure to credit risk, liquidity risk and market risk arises in the normal course of Hydro's business.

**14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)**

**Risk Management (cont'd.)**

Hydro

(a) Credit Risk

Hydro is exposed to credit risk in the event of non performance by counterparties to its financial instruments. The majority of Hydro's receivables are from regulated utilities which minimizes credit risk. There is risk that Hydro will not be able to collect all of its remaining accounts receivable and amounts owing under its customer finance plans. These financial instruments which arise in the normal course of business do not represent a significant concentration of credit risk as amounts are owed by a large number of customers on normal credit terms. Hydro manages this credit risk primarily by executing its credit and collection policy including the requirement for security deposits from certain customers.

Hydro manages its investment credit risk exposure by restricting its investments to high quality securities such as Canada Treasury Bills, Bankers' Acceptances drawn on Schedule 1 Canadian Chartered Banks and Term Deposits issued by Schedule 1 Canadian Chartered Banks.

(b) Liquidity Risk

Hydro is exposed to liquidity risk with respect to its contractual obligations and financial liabilities. Hydro manages this risk by maintaining borrowing facilities sufficient to cover both anticipated and unexpected fluctuations within the operations and by continuously monitoring cashflows. Short-term liquidity is provided through cash and cash equivalents on hand, funds from operations, a $300.0 million promissory note program and a $50.0 million operating credit facility. Long-term liquidity risk is managed by the issuance of a portfolio of debentures with maturity dates ranging from 2014 to 2033. Sinking funds have been established for these issues.

(c) Market Risk

Market risk refers primarily to the risk of loss resulting from changes in interest rates, commodity prices and foreign exchange rates. During 2009, the Board of Directors of Nalcor, approved a formal financial risk management policy that outlined the risks associated with the operations of Nalcor and its subsidiaries and approaches and guidelines to be followed in the management of those risks. This policy will be reviewed by the Board annually or more frequently if there is a material change to Nalcor's financial risks and outlines a formal approval process for various hedging instruments used. The Audit Committee will provide oversight on behalf of the Board with the exception of any items that specifically require Board approval.

*Interest Rates*

Interest rate risk is managed within the corporate financing strategy where floating rate debt exposures and interest rate scenarios are forecast and evaluated. A diversified portfolio of fixed and floating rate debt is maintained and managed with a view to an acceptable risk profile. Key quantitative parameters for interest rate risk management are the percentage of floating rate debt in the total debt portfolio, coupled with an examination of the weighted average term to maturity of the entire debt portfolio. By setting clear guidelines in respect to these quantitative parameters, Hydro attempts to minimize the likelihood of a material impact on net income resulting from an unexpected change in interest rates.

Exposure to changes in interest rates exists on interest expense related to the short-term debt portfolio and interest income related to the sinking fund investment portfolios. Hydro estimates that a change of 100 basis points from the actual average yield on the short-term debt portfolio in 2009 would have resulted in a change in interest expense of $0.5 million (2008 – $1.3 million). Similarly, a change of 100 basis points from the actual average yield on the sinking fund investment portfolio in 2009 would have resulted in a change in interest income of $2.3 million (2008 – $2.0 million) and a change in other comprehensive income of $16.6 million (2008 - $16.1 million). Interest rate risk on the long-term debt portfolio is mitigated through the use of fixed rate debentures.

**14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)**

**Risk Management (cont'd.)**

Hydro (cont'd)

(c) Market Risk (cont'd.)

*Foreign Currency and Commodity Exposure*
Fair value of future cash flows of a financial instrument will fluctuate due to changes in the exchange rate between the foreign currency and the Canadian dollar. Hydro's primary exposure to both foreign exchange and commodity price risk arise from its purchases of No. 6 fuel for consumption at the HTGS and certain electricity sales both of which are denominated in US dollars.

During 2009, Hydro had total purchases of No. 6 fuel of $87.5 million (2008 - $103.9 million) denominated in US dollars. Hydro's exposure to both the foreign exchange and commodity price risk associated with these fuel purchases is mitigated through the operation of the RSP. The purpose of the RSP is to both reduce volatility in customer rates as well as mitigate potential net income volatility from fuel price and volume variations. All variances in actual fuel prices and exchange rates, as compared to that approved in Hydro's most recent cost of service study used to set rates, are captured in the RSP and are either refunded to or collected from customers through automatic rate adjustments. Hydro also employs the periodic use of forward currency contracts to avoid exposure to exchange rates on a particular day can be avoided.

During 2009, total electricity sales denominated in US dollars were $42.5 million. Hydro mitigates this risk through the use of forward contracts. During 2009, Hydro entered into a series of 24 monthly foreign currency forward contracts, the last of which matures April 2011, in the amount of $87.8 million US dollars at an average exchange rate of 1.17 to hedge 75% of Hydro's forecasted US dollars sales. The nominal contract value range from $2.4 million to $6.0 million. During the year, eight of the contracts were settled with the effective portion of the gain reported as energy sales and the ineffective portion as other income. The fair value of the 16 contracts outstanding as at December 31, 2009 is $7.0 million. These contracts have been designated as part of a hedging relationship.

**Effect of Hedge Accounting on Financial Statements**

| *(millions of dollars)* | **Net Gains Included in Net Income** | **Unrealized Gains Included in OCI** |
|---|---|---|
| Ineffective portion | 0.5 | - |
| Effective portion | 2.4 | 6.2 |

Churchill Falls

(a) Liquidity Risk
Churchill Falls is exposed to liquidity risk with respect to its contractual obligations and financial liabilities. Churchill Falls manages this risk by maintaining borrowing facilities sufficient to cover both anticipated and unexpected fluctuations within its operations and by continuously monitoring cash flows. Short-term liquidity is provided through cash and cash equivalents on hand, funds from operations and the $10.0 million unsecured credit facility. Long-term liquidity risk is managed by maintenance of the reserve fund in accordance with the June 1999 shareholders' agreement and dividend management policy to meet long-term liquidity requirements associated with debt retirement and the company's capital expenditure program.

## 14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)

**Risk Management (cont'd.)**

Churchill Falls (cont'd)

(b) Market Risk
Market risk refers primarily to the risk of loss resulting from changes in interest rates, foreign exchange rates and commodity prices.

*Interest Rates*
Interest rate risk is mitigated on Churchill Falls' long-term debt by virtue of a fixed interest rate to maturity. Exposure to changes in interest rates exists on investment income related to the short-term and reserve fund investment portfolios. Churchill Falls estimates that a change of 100 basis points from the actual average yield earned on the short-term investment portfolio in 2009 would have resulted in a change in interest income of $0.1 million (2008 – $0.2 million). Similarly, a change of 100 basis points from the actual average yield earned on the reserve fund investment portfolio in 2009 would have resulted in a change in interest income of $0.3 million (2008 – $0.2 million) and a change in other comprehensive income of $0.8 million (2008 - $0.5 million). Interest rate risk is managed within the corporate financing strategy where floating rate debt exposures and interest rate scenarios are forecast and evaluated.

*Foreign Currency Exposure*
The fair value or future cash flows of a financial instrument will fluctuate due to changes in foreign exchange rate between a foreign currency and the Canadian dollar. Churchill Falls is exposed to foreign exchange risk when it enters into transactions to procure goods and services denominated in a foreign currency however this exposure to foreign exchange rate fluctuations is immaterial.

*Commodity*
Churchill Falls does not hold any financial instrument whose value would vary due to changes in a commodity price.

## 15. INTEREST EXPENSE

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Gross Interest | | |
| Long-term debt | 92.0 | 96.0 |
| Promissory notes | 0.6 | 4.2 |
| | 92.6 | 100.2 |
| Accretion of long-term debt | 0.4 | 0.5 |
| Amortization of foreign exchange losses | 2.2 | 2.2 |
| Other | 7.0 | 2.8 |
| | 102.2 | 105.7 |
| Less | | |
| Recovered from Hydro-Québec | - | 0.1 |
| Interest capitalized during construction | 0.8 | 9.6 |
| Interest earned | 17.6 | 17.2 |
| Net interest expense | 83.8 | 78.8 |

With the refinancing of the General Mortgage Bonds in February 2008, Churchill Falls is required to share with Hydro-Québec any benefits it receives resulting from the respective change in interest rates. Prior to the refinancing, Churchill Falls recovered the difference between interest calculated at the rates prescribed in the Power Contract and interest paid on its long-term debt.

## 15. INTEREST EXPENSE (cont'd.)

Also, Churchill Falls can request Hydro and Hydro-Québec to make advances, against the issue of Subordinated Debt Obligations, to service its debt and to cover expenses if funds are not otherwise available. If such requests fail to attract sufficient advances, Churchill Falls can require Hydro-Québec to make additional advances, against the issue of units of Subordinate Debentures and shares of common stock, to service its debt and to cover its expenses that remain unfunded.

## 16. CHANGES IN NON-CASH OPERATING WORKING CAPITAL BALANCES

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Accounts receivable | (9.0) | 3.6 |
| Fuel and supplies | (6.8) | 17.0 |
| Prepaid expenses | (0.6) | (0.4) |
| Accounts payable and accrued liabilities | 7.3 | (20.8) |
| Regulatory assets | 5.5 | 18.9 |
| Regulatory liabilities | 68.8 | 14.8 |
| Accrued interest | - | (2.0) |
| Employee future benefits | 2.5 | 3.0 |
| Long-term receivables | 2.0 | (2.9) |
| Long-term payable | 3.6 | 0.7 |
| Due to related parties | 18.0 | (0.2) |
| Long-term related party note payable | 23.9 | - |
| | 115.2 | 31.7 |

## 17. SEGMENT INFORMATION

Hydro operates in four business segments. Hydro Regulated encompasses sales of electricity to customers within the Province. Churchill Falls operates a hydroelectric generating facility and sells electricity primarily to Hydro-Québec. Nalcor's energy marketing activities include the sale of electricity to markets outside the Province. Other encompasses other non-regulated activities. The designation of segments has been based on a combination of regulatory status and management accountability. The segments' accounting policies are the same as those previously described in Note 1.

**Segments**

| *(millions of dollars)* | Hydro Regulated | Energy Marketing | Churchill Falls | Other | Inter-Segment | Total |
|---|---|---|---|---|---|---|
| | | | 2009 | | | |
| Revenue | | | | | | |
| Energy sales | 443.8 | 54.7 | 61.0 | 6.0 | (3.9) | 561.6 |
| Other | 2.2 | 0.7 | 0.3 | - | 1.3 | 4.5 |
| | 446.0 | 55.4 | 61.3 | 6.0 | (2.6) | 566.1 |
| Expenses | | | | | | |
| Operations and administration | 100.9 | 17.2 | 37.7 | 3.3 | - | 159.1 |
| Fuels | 155.2 | - | - | - | - | 155.2 |
| Power purchased | 46.8 | 4.2 | - | - | (3.9) | 47.1 |
| Amortization | 41.7 | - | 12.8 | - | - | 54.5 |
| Interest | 83.5 | - | 0.4 | (0.1) | - | 83.8 |
| | 428.1 | 21.4 | 50.9 | 3.2 | (3.9) | 499.7 |
| Net income from operations | 17.9 | 34.0 | 10.4 | 2.8 | 1.3 | 66.4 |
| Preferred dividends | - | - | 1.3 | - | (1.3) | - |
| Net income | 17.9 | 34.0 | 11.7 | 2.8 | - | 66.4 |
| | | | | | | |
| Capital expenditures | 54.1 | - | 3.7 | - | - | 57.8 |
| Total assets | 1,766.0 | 10.2 | 420.5 | 24.8 | (0.8) | 2,220.7 |

**17. SEGMENT INFORMATION (cont'd.)**

**Segments (cont'd.)**

| *(millions of dollars)* | Hydro Regulated | Energy Marketing | Churchill Falls | Other | Inter-Segment | Total |
|---|---|---|---|---|---|---|
| | | | 2008 | | | |
| Revenue | | | | | | |
| Energy sales | 440.1 | 51.3 | 68.9 | 6.9 | (3.9) | 563.3 |
| Other | 2.2 | - | 0.3 | - | 3.1 | 5.6 |
| | 442.3 | 51.3 | 69.2 | 6.9 | (0.8) | 568.9 |
| Expenses | | | | | | |
| Operations and administration | 99.1 | - | 38.8 | 3.9 | - | 141.8 |
| Fuels | 164.8 | - | - | - | - | 164.8 |
| Power purchased | 41.4 | 3.5 | - | - | (3.9) | 41.0 |
| Amortization | 40.4 | - | 12.6 | - | - | 53.0 |
| Interest | 87.6 | - | 0.1 | (8.9) | - | 78.8 |
| Write-down of investments | - | - | - | 2.7 | - | 2.7 |
| | 433.3 | 3.5 | 51.5 | (2.3) | (3.9) | 482.1 |
| Net income from operations | 9.0 | 47.8 | 17.7 | 9.2 | 3.1 | 86.8 |
| Preferred dividends | - | - | 3.1 | - | (3.1) | - |
| Net income | 9.0 | 47.8 | 20.8 | 9.2 | - | 86.8 |
| | | | | | | |
| Capital expenditures | 45.6 | - | 4.3 | 40.2 | - | 90.1 |
| Total assets | 1,711.4 | 3.7 | 414.4 | 21.7 | (9.7) | 2,141.5 |

During 2009, sales to Hydro's three largest customers amounted to over 80% of total energy sales.

**Geographic Information**

Revenues by geographic area:

| *(millions of dollars)* | 2009 | 2008 |
|---|---|---|
| Newfoundland and Labrador | 453.1 | 447.3 |
| Québec | 69.8 | 121.6 |
| Nova Scotia | 39.7 | - |
| New Brunswick | 3.5 | - |
| | 566.1 | 568.9 |

All of Hydro's assets are located in the Province.

**18. COMMITMENTS AND CONTINGENCIES**

(a) Under the terms of a sublease with Twin Falls, expiring on December 31, 2014, Churchill Falls is required to deliver to Twin Falls, at an agreed price, horsepower equivalent to the installed horsepower of the Twin Falls plant and to maintain Twin Falls' plant and equipment. The costs associated with making the plant operational, if required, are not estimable at this time. In 2015, the physical assets of Twin Falls will revert to Churchill Falls, and Churchill Falls is required to make this horsepower available to Hydro at rates that are commercially reasonable pursuant to the 1999 shareholders' agreement.

**18. COMMITMENTS AND CONTINGENCIES (cont'd.)**

(b) The results of an Environmental Site Assessment (ESA) conducted at the Twin Falls Generating Station indicated higher than acceptable concentrations of contaminants in the soil and waters adjacent to the powerhouse. Further testing was conducted to determine the extent of contamination. The recommendations arising from this testing indicate that remediation is not required, but further monitoring be carried out. Further monitoring is recommended for 2010 and every five years thereafter.

(c) Pursuant to the terms of the 1999 shareholders' agreement, in 2007, Churchill Falls commenced the creation of a $75.0 million segregated reserve fund to contribute towards the funding of capital expenditures related to Churchill Falls' existing facilities and their replacement. Churchill Falls invested $17.0 million in each of 2007, 2008 and 2009. The remaining investments will be acquired during a 30-day period commencing on each of the following dates:

| | |
|---|---|
| January 1, 2010 | $8.0 million |
| January 1, 2011 | $8.0 million |
| January 1, 2012 | $8.0 million |

This fund must remain in place until the end of the shareholders' agreement in 2041. Any amounts removed to fund capital expenditures must be replaced. Reserve fund holdings consist of securities issued by the Government of Canada, various provinces of Canada and Schedule 1 Canadian Chartered Banks.

A summary of Hydro's 65.8% share of the reserve fund is as follows:

| *(millions of dollars)* | **2009** | 2008 |
|---|---|---|
| Opening balance | **23.4** | 11.2 |
| Contribution | **11.2** | 11.2 |
| Total contribution to reserve fund | **34.6** | 22.4 |
| Net interest earned | **(0.2)** | 0.4 |
| Mark-to-market adjustment | **0.4** | 0.6 |
| Fair value of reserve fund | **34.8** | 23.4 |

(d) Hydro has received claims instituted by various companies and individuals with respect to outages and other miscellaneous matters. Although such matters cannot be predicted with certainty, management currently considers Hydro's exposure to such claims and litigation, to the extent not covered by insurance policies or otherwise provided for, to be $0.1 million (2008 - $0.2 million).

One of Hydro's industrial customers commenced legal proceedings in 1997, claiming approximately $21.9 million (2008 - $22.2 million) related to outages and plant shutdowns. Hydro is defending this claim. While the ultimate effect of such an action cannot be ascertained at this time, in the opinion of Hydro's management, following consultation with its legal counsel, no liability should be recognized.

(e) Outstanding commitments for capital projects total approximately $13.3 million (2008 - $7.1 million).

**18. COMMITMENTS AND CONTINGENCIES (cont'd.)**

(f) Hydro has entered into a number of long-term power purchase agreements as follows:

| Type | Rating | In-service Date | Term |
|---|---|---|---|
| Hydroelectric | 175 kW | 1988 | Continual |
| Hydroelectric | 3 MW | 1995 | 25 years |
| Hydroelectric | 4 MW | 1998 | 25 years |
| Cogeneration | 15 MW | 2003 | 20 years |
| Wind | 390 kW | 2004 | 15 years |
| Wind | 27 MW | 2008 | 20 years |
| Wind | 27 MW | 2009 | 20 years |

Estimated payments due in each of the next five years are as follows:

| *(millions of dollars)* | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Power purchases | 27.0 | 27.6 | 28.5 | 29.5 | 30.2 |

On December 16, 2008, the Province introduced legislation cancelling two power purchase agreements related to hydro facilities.

(g) Hydro has issued two irrevocable letters of credit, one in the amount of $7.2 million to the New Brunswick System Operator as credit support related to an application for point to point transmission service. The second letter of credit has been issued to the Department of Fisheries and Oceans in the amount of $0.3 million as a performance guarantee in relation to the Fish Habitat Compensation Agreement. Churchill Falls has issued an irrevocable letter of credit, in the amount of $0.7 million to ensure satisfactory management of its waste management and compliance with a certificate of approval for the transportation of special hazardous wastes, granted by the Department of Environment and Conservation.

(h) Effective March 31, 2009, Hydro's five-year power sales agreement to sell energy to Hydro-Québec expired. Effective April 1, 2009, Hydro has entered into a power sales agreement with a third party with respect to the energy previously sold to Hydro-Québec. To facilitate market access, Hydro has entered into a five-year transmission service agreement with Hydro-Québec TransÉnergie to acquire access to 265 MW of transmission capacity from Labrador through Québec. Hydro has the right to renew its transmission service contract at the end of the contract term. If at that time there is a competing request for the same path, in order to renew the service agreement, Hydro must agree to accept a contract term that is at least equal to that competing request.

Pursuant to Hydro's five-year transmission service agreement with Hydro-Québec TransÉnergie, the transmission rental payments for the next five years are as follows:

| | |
|---|---|
| 2010 | $ 19.2 million |
| 2011 | $ 19.2 million |
| 2012 | $ 19.2 million |
| 2013 | $ 19.2 million |
| 2014 | $ 4.8 million |

(i) Hydro has received funding in the amount of $2.5 million from the Atlantic Canada Opportunities Agency in relation to a wind-hydrogen-diesel research development project in the community of Ramea; this funding is repayable by annual installments of $25,000 per commercial implementation of the resulting product. As at December 31, 2009, there have been no commercial implementations.

## 19. RELATED PARTY TRANSACTIONS

The Province, Nalcor, Churchill Falls, Nalcor Energy – Oil and Gas, Nalcor Energy – Bull Arm Fabrication, LCDC and GIPCo are related parties of Hydro. In addition, the PUB is related to Hydro by virtue of its status as an agency of the Province. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

(a) Hydro has entered into a long-term power contract with Churchill Falls for the purchase of $5.9 million (2008 - $6.0 million) of the power produced by Churchill Falls and Hydro's 65.8% share is eliminated upon consolidation.

(b) For the year ended December 31, 2009, approximately $1.9 million (2008 - $1.8 million) of operating costs were recovered from Churchill Falls for engineering, technical, management and administrative services. Hydro's 65.8% share is eliminated upon consolidation.

(c) Hydro is required to contribute to the cost of operations of the PUB as well as pay for the cost of hearings into applications it makes. During 2009, Hydro incurred $0.6 million in costs related to the PUB (2008 - $0.6 million) of which $0.1 million (2008 - $0.1 million) was included in accrued liabilities.

(d) As at December 31, 2009 Hydro has a payable to Nalcor of $20.8 million (2008- $2.9 million) and a payable to Churchill Falls of $0.1 million (2008 – nil). This payable consists of various intercompany operating costs.

(e) Under the terms and conditions of the Churchill Falls (Labrador) Corporation (Lease) Act, 1961, Churchill Falls must pay rentals and royalties to the Province annually. As at December 31, 2009 $2.4 million (2008 - $3.3 million) was payable.

(f) During 2008, certain assets and liabilities and their related debt and equity were transferred from Hydro to Nalcor Energy. Details of the transactions are noted below:

| *(millions of dollars)* | 2008 |
|---|---|
| Property, plant and equipment | 157.2 |
| Contributed capital | (2.2) |
| Employee future benefits | (0.5) |
| Retained earnings from non-regulated activity in Hydro | (160.6) |
| Total | (6.1) |

(g) During 2009, Nalcor advanced $1.1 million (2008 - $4.5 million) as a contribution in aid of construction related to the Ramea Wind-Hydrogen-Diesel Project. Hydro also received contributions in aid of construction from the Province related to wind feasibility studies. As at December 31, 2009, the full amount of $0.2 million has been recorded as a deferred capital contribution.

(h) During 2009, Hydro received $0.4 million (2008 - $0.4 million) as a rate subsidy for rural isolated customers from the Province and $1.6 million (2008 - $1.5 million) as an energy rebate to offset the cost of basic electricity consumption for Labrador rural isolated residential customers under the Northern Strategic Plan with $0.1 million (2008 - $0.1 million) recorded as accounts receivable at year-end.

## 20. SIGNIFICANT OCCURRENCES

On November 3, 2008, a fire occurred in a cable shaft at Churchill Falls causing extensive damage to two sets of high-voltage cables in two units of the cable shaft. This resulted in lost GWAC revenue and power sales of approximately $7.7 million and $2.5 million in 2009 and $8.4 million and $2.1 million in 2008.

Hydro's share of total repair costs of $5.3 million as of December 31, 2009 were covered by insurance with the exception of a $1.3 million deductible. Repair work was completed on the first unit in February 2009 and the second unit in October 2009.

## 21. WATER MANAGEMENT AGREEMENT

In June 2007, the Province passed an amendment to the Electrical Power Control Act, 1994 ("EPCA"). The amendment requires parties, that utilize a common water resource in the province for power production, enter into a water management agreement. If the parties cannot reach an agreement, the Board of Commissioners of Public Utilities ("PUB") has the authority to impose an agreement on the parties. Churchill Falls shares the Churchill River with a Nalcor proposed hydroelectrical generation development, downstream from Churchill Falls. The amendment provides that any resulting water management agreement will not adversely affect existing power contracts.

A tentative agreement reached between management of Nalcor and Churchill Falls was not approved by the Churchill Falls Board of Directors. As a result, on November 10, 2009 Nalcor applied to the PUB to establish the terms of the agreement.

## 22. SUBSEQUENT EVENTS

(a) In January 2010, Hydro entered into 28 swap contracts to hedge the commodity price risk on electricity sales in the amount of $24.7 million.

(b) On February 23, 2010, Churchill Falls filed a motion against Hydro-Quebec in the Quebec Superior Court. The motion is seeking a modification to the pricing terms of the 1969 Power Contract as of November 30, 2009. The outcome of this motion is not determinable at this time.

On February 3, 2010, the Province established a trust with Churchill Falls as the beneficiary. The purpose of this trust is to fund the external costs and expenses incurred in relation to this matter.

(c) In February 2010, Hydro issued 22 letters of credit, for transmission bookings, reducing the availability of its credit facility by $11.5 million.

(d) On March 9, 2010, the PUB issued a board order establishing the water management agreement proposed by Nalcor in November 2009.