Court File No CV-12-9566-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED
AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF TERRACE BAY PULP INC.

FIRST REPORT OF THE MONITOR DATED JANUARY 27, 2012

INTRODUCTION

1. On January 25, 2012, Terrace Bay Pulp Inc. ("**Terrace Bay**" or the "**Applicant**") filed for and obtained protection under the *Companies' Creditors Arrangement Act* (the "**CCAA**"). Pursuant to an Order of this Court dated January 25, 2012 (the "**Initial Order**"), Ernst & Young Inc. ("**EYI**") was appointed as Monitor (the "**Monitor**") in the CCAA proceeding. The Initial Order provided for a stay of proceedings through February 24, 2012 (the "**Stay Period**").

2. On January 24, 2012, EYI filed with this Court a report (the "**Pre-Filing Report**") detailing certain construction and repair projects that were ongoing at Terrace Bay's mill (the "**GTP Projects**"). Further details related to the GTP Projects were contained in affidavit of Mr. Wolfgang Gericke sworn January 25, 2012 (the "**Gericke Affidavit**") and the affidavit of Taras Sawula sworn January 27, 2012 (the "**Sawula Affidavit**").

PURPOSE

3. The purpose of this report of the Monitor (the "**First Report**" or this "**Report**") is to update the Court in relation to the Applicant's motion to obtain authorization to continue the GTP Projects and to pay all amounts due to contractors working on the GTP Projects, whether incurred before or after the date of the Initial Order. Such funds would only be paid to the relevant contractor after receiving funding from Natural Resources Canada ("**NRC**"), which funds shall be deemed to be held in trust by Terrace Bay for such

contractors, and would not be available to other creditors of the Applicant. The Applicant is also seeking confirmation from NRC that all invoices and receipts properly submitted in accordance with the relevant agreements after the date of the Initial Order will be funded by NRC prior to the Applicant re-commencing work in relation to the GTP Projects.

TERMS OF REFERENCE

4. In preparing this Report, EYI has been provided with and in making the comments herein it has relied upon, unaudited financial information, Terrace Bay's books and records, financial information prepared by Terrace Bay, and discussions with management of Terrace Bay. EYI has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such information and, accordingly, EYI expresses no opinion or other form of assurance in respect of such information contained in this Report. Some of the information referred to in this Report consists of forecasts and projections. An examination or review of the financial forecast and projections, as outlined in the Canadian Institute of Chartered Accountants ("**CICA**") Handbook, has not been performed. Future oriented financial information referred to in this Report was prepared based on management's estimates and assumptions. Readers are cautioned that since projections are based upon assumptions about future events and conditions that are not ascertainable, the actual results will vary from the projections, even if the assumptions materialize, and the variations could be significant.

GREEN TRANSFORMATION PROGRAM AND THE GTP PROJECTS

5. Prior to the commencement of this CCAA proceeding, Terrace Bay was participating in the Green Transformation Program (the "**GTP**"). This program, administered by NRC, provides funding for projects that have an environmental benefit. Such benefits include energy efficiency or production of "green" energy.

6. The Applicant has advised that Monitor that the GTP Projects currently underway at Terrace Bay are required to be completed, as laws relating to emissions created by an operational mill will be changing in 2013. As such, the completion of the GTP Projects is required in order for Terrace Bay to remain compliant with the new emissions standards.

7. The Monitor understands from Terrace Bay that the GTP runs only until March 31, 2012, such that there is limited time to for it to complete the GTP Projects. In addition to the requirements and limits noted above, the completion of the GTP Projects may make the mill a more attractive acquisition opportunity for potential buyers in the Sales Process (as defined in the Pre-Filing Report) that is currently underway.

8. Terrace Bay has incurred certain pre-filing liabilities for work related to the GTP Projects. Terrace Bay advises that such liabilities are reimbursable by NRC pursuant to its agreements with NRC. Given that this work was done pre-filing, the related payments to suppliers would ordinarily be stayed. The Sawula Affidavit contains particulars of certain claims for lien that have been asserted for work relating to the GTP Projects.

9. The Monitor has reviewed email correspondence from Terrace Bay and its counsel and from NRC indicating that NRC is willing to continue to finance the GTP Projects on a post-filing basis, with certain assurances from Terrace Bay, including that $420,000 owed to suppliers of the GTP Projects (for which payment was previously received by Terrace Bay from NRC) be paid to such suppliers and that any future amounts paid to Terrace Bay by NRC be held in trust by Terrace Bay for project contractors and not be made available to other creditors of Terrace Bay. Thus, while pre-filing creditors would be paid from further funds received from NRC, NRC appears unwilling to pay over additional funds if they are not to be used for the GTP Projects.

10. Terrace Bay has already been funded approximately $420,000 from NRC in relation to work done by contractors prior to the shutdown of the mill on October 31, 2011. If the Applicant’s motion is granted, such funds would be paid to the relevant contractors from funds currently on hand, as this would facilitate the payment of another amount of

approximately $5 million related to work done on the GTP Projects in November and December, 2011.

11. The cash flow forecast appended as Exhibit “K” to the Gericke Affidavit (the “**Cash Flow Forecast**”) and as Appendix “A” to the Pre-Filing Report, indicates that payments from NRC are expected to be received in the amount of $4,626,099 in the week of February 12, 2012 and $641,955 in the week of February 19, 2012. The Applicant anticipated that payments in these same amounts would be made to contractors for work performed on the GTP Projects during those same weeks.

12. The Monitor notes that the Cash Flow Forecast projects approximately $6.9 million in additional payments potentially to be received by Terrace Bay from NRC for future work on the GTP Projects, if they continue to completion, thereby facilitating the mill’s ability to comply with future environmental standards taking advantage of this federal funding program.

13. The Sawula Affidavit indicates that a delay in holding the GTP Hearing until February 2, 2012 could jeopardize the completion of the GTP Projects by March 31, 2012. Given the short time frame contemplated by the Sales Process, the Monitor is of the view that this is not unreasonable in the circumstances.

14. EYI is of the view that payment to contractors for work related to the GTP Projects of the amounts described by Terrace Bay in the materials it is filing with this Court is reasonable in the circumstances, as funding is derived from payments from NRC and the GTP Projects, if completed, could enhance the marketability of the mill.

All of which is respectfully submitted this 27th day of January, 2012.

ERNST & YOUNG INC.
In its capacity as the Court-Appointed Monitor of Terrace Bay Pulp Inc.

Per:

Alex Morrison
Senior Vice President