Court File No. ****

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.

REPORT OF THE PROPOSED MONITOR DATED JANUARY 24, 2012

INTRODUCTION

1. Terrace Bay Pulp Inc. ("**Terrace Bay**" or the "**Applicant**") operates a pulp mill in the Town of Terrace Bay, Ontario (the "**Town**"). The Town is located on the north shore of Lake Superior. Terrace Bay's customers include large tissue and paper producers in North America and overseas. The primary raw material for Terrace Bay's products is wood fibre sourced from nearby timberlands.

2. Terrace Bay is the dominant economic entity in the Town and the surrounding area and provides employment for a significant proportion of residents in the Town and another nearby community, Schreiber, Ontario. The mill, when it is at full production, employs approximately 375 people on a full time basis.

3. On March 11, 2009, Terrace Bay filed for and obtained protection under the *Companies' Creditors Arrangement Act* (the "**CCAA**"). Pursuant to an Order of the Court dated March 11, 2009, Ernst & Young Inc. ("**EYI**") was appointed as Monitor (the "**2009 Monitor**") in this proceeding (the "**First CCAA Proceedings**"). During the First CCAA Proceedings, Terrace Bay did not operate its mill due to weak pulp market conditions as well as a lack of liquidity. However, Terrace Bay was able to pay off its secured debt by converting its working capital assets into cash and was also able to fund the maintenance and heating of its mill equipment pending a strengthening of pulp market conditions. Pulp market conditions did improve in 2010, which enabled Terrace Bay to secure new financing and to negotiate a restructuring plan with its creditors.

4. Terrace Bay emerged from the First CCAA Proceedings on September 15, 2010 after receiving creditor and Court approval of Terrace Bay's CCAA Plan of Compromise and Arrangement (the "**CCAA Plan**") and resumed its operations immediately.

5. The Order of this Court sanctioning the CCAA Plan provides for EYI's discharge as the 2009 Monitor upon its completion of certain matters. As of this date, EYI's appointment as the 2009 Monitor continues for the purpose of allowing it to complete its duties under the claims process in the First CCAA Proceedings. EYI wishes to retain the discretion to suspend performance of any remaining duties as the 2009 Monitor if it appears appropriate to do this having regard to the anticipated recovery under the Plan Note (as defined herein).

6. For the reasons explained further herein, EYI understands that Terrace Bay has brought an application under the CCAA seeking, among other things, an order commencing new proceedings under the CCAA in order to allow it to commence a sales process to market a going concern sale of the business of Terrace Bay, by way of an asset or share sale. EYI has prepared this report (the "**Report**") to provide the Court with certain background information and to confirm its agreement to act as monitor (in such capacity, the "**Monitor**") of Terrace Bay should the Court see fit to grant such an order.

7. The CCAA Plan provided that unsecured creditors of Terrace Bay were to participate (on a *pro rata* basis) in a promissory note (the "**Plan Note**"). By its terms, the amount payable on maturity of the Plan Note is between $10 million and $30 million, as determined based on certain cumulative net income of Terrace Bay following its emergence from the First CCAA Proceedings. The term of the Plan Note is six years, although certain provisions of the Plan Note allow for earlier repayment and acceleration. The Plan Note is secured by a subordinated charge on the assets of Terrace Bay. The trustee of the Plan Note is Computershare Trust Company of Canada ("**Computershare**").

8. In order to fund its emergence from the First CCAA Proceedings, which emergence occurred on September 15, 2010, Terrace Bay entered into an asset-based loan facility (the "**Callidus Loan**") with Callidus Capital ("**Callidus**"), a Toronto-based financier.

The Callidus Loan was secured by a first charge on Terrace Bay's working capital assets and a subordinated charge on the fixed assets. The Callidus Loan was guaranteed by certain related parties to Terrace Bay. All obligations of Terrace Bay under the Callidus Loan, as of the date of this Report, have been fully repaid or cash collateralized, and the Callidus Loan will not be drawn upon further by Terrace Bay.

9. Payment under the Plan Note is expressly subordinated to payment of "**Senior Indebtedness**", as defined under the Plan Note to include, among other things, indebtedness under the Province Loan (as defined herein) and other agreements with the Province (as defined herein) and indebtedness under the Callidus Loan.

10. On emergence from the First CCAA Proceedings, Terrace Bay also entered into a term loan (the "**Province Loan**") with the Province of Ontario (the "**Province**") in the amount of \$25 million. The Province Loan is secured by a charge against the fixed assets and a subordinated charge against the working capital assets of Terrace Bay and has a term of six years. The Monitor understands that two payments were made by Terrace Bay towards satisfying the Province Loan and that the current outstanding principal balance is approximately \$24.2 million.

11. Details regarding further secured creditors and potential lien claimants can be found in the affidavit of Mr. Wolfgang Gericke in Terrace Bay's filing materials.

12. Subsequent to emergence from the First CCAA Proceedings, Terrace Bay restarted the mill and operated until October 31, 2011, at which time the blow tank in the mill exploded, resulting in an employee fatality and damage to certain equipment. The mill was idled for an investigation at that time. Subsequently, the mill was restarted for a period of time to consume remaining raw materials. However, due to a lack of liquidity in part due to the shutdown resulting from the accident, the mill was again idled on December 4, 2011.

13. As of the date of this Report, the mill remains idled and activity at the Terrace Bay mill site is limited to heating the mill to prevent damage to the equipment and the mill that could be caused by cold winter weather, repairing production equipment damaged by the

explosion and selling finished goods to existing customers. Terrace Bay continues to collect customer accounts receivable.

14. Terrace Bay has advised EYI that, according to its books and records, the amount owing to trade creditors, as of the date of this Report, including intercompany payables, is estimated to be approximately $14.5 million.

15. Terrace Bay has limited cash resources remaining, and does not have sufficient liquidity to restart its operations once market conditions improve. As a result, it must conserve its remaining liquidity to heat the mill and otherwise preserve the mill assets until such time as a buyer can be found.

16. For these reasons, Terrace Bay has determined it necessary to commence new proceedings under the CCAA. EYI understands that the proceedings will be focused identifying and negotiating a sale of the assets and operations of Terrace Bay.

TERMS OF REFERENCE

17. 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.

THE SALES PROCESS

18. Terrace Bay has determined that in order to recapitalize the mill and to best position it for survival for the long term, it must be sold to a better capitalized operator who can fund the necessary capital needs of the business. As such, Terrace Bay intends to pursue a marketing process for the sale of the business (the "**Sales Process**"). The Sales Process must be completed on an expeditious basis, while Terrace Bay has sufficient funds to pay the heating and other conservatory costs of the mill.

19. The terms of the Sales Process are set out in Exhibit "J" of the affidavit of Wolfgang Gericke submitted in support of Terrace Bay's application. The more significant milestones in the Sales Process are:

Activity	**Timeline**
Solicitation of potential purchasers	Competed by February 15, 2012
Submission of non-binding letters of intent	February 15, 2012
Identification of qualified bidders	Notified by February 17, 2012
Management presentations	February 21 to February 24, 2012
Further due diligence	February 17 to March 16, 2012
Submission of offers	March 16, 2012
Identification of purchaser	March 19, 2012
Target closing date	April 16, 2012

20. EYI has assisted Terrace Bay in the development of the proposed Sale Process. EYI is of the view that the Sales Process will provide the ability to reasonably canvass the market, having regard to the current circumstances and funding available, in an attempt to find a buyer for the mill.

GREEN TRANSFORMATION PROGRAM

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

22. Terrace Bay has incurred liabilities in respect of projects related to its two projects under the GTP (the "**GTP Projects**"). Such liabilities, pursuant to the GTP Projects, are reimbursable by NRC once approved by it. Given that this work was done pre-filing (and Terrace Bay anticipates continuing post-filing), the related supplier liabilities would ordinarily be stayed by the Initial Order. Terrace Bay is of the view that the non-payment of these obligations would result in NRC not reimbursing Terrace Bay the associated grant payments and would bring an end to the GTP Projects.

23. Terrace Bay's motion materials indicate that it has significant liabilities related to the GTP Projects, and that it wishes to pay the relevant contractors once reimbursement from NRC has been obtained. Terrace Bay has told EYI that these payments will allow it to remain compliant with provisions of the GTP. EYI understands from Terrace Bay that completion of the GTP Projects will make the mill more attractive to potential purchasers.

24. 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 completion of the GTP Projects could enhance the marketability of the mill.

OVERVIEW OF TERRACE BAY'S CASH FLOW FORECAST

25. Terrace Bay, with the assistance of EYI, has prepared a Cash Flow Projection (the "**Cash Flow Forecast**") for the period from January 22, 2012 to May 5, 2012. A copy of the Cash Flow Forecast as attached as Exhibit "K" to the affidavit of Wolfgang Gericke submitted in support of Terrace Bay's initial application and is reproduced as Appendix "A" to this Report. The Cash Flow Forecast has been prepared by management of

Terrace Bay for the purpose of the Initial Application, using probable and hypothetical assumptions set out in notes 1 to 9 attached to the Cash Flow Forecast. The Cash Flow Forecast reflects receipts and disbursements to be received or paid over the 15-week projection period in Canadian dollars.

26. EYI's review of the Cash Flow Forecast consisted of inquiries, analytical procedures and discussion related to information supplied to EYI by certain of the management and employees of Terrace Bay. Since hypothetical assumptions need not be supported, EYI's procedures with respect to them were limited to evaluating whether they were consistent with the purpose of the Cash Flow Forecast. EYI has also reviewed the support provided by management of Terrace Bay for the probable assumptions, and the preparation and presentation of the Cash Flow Forecast.

27. Based on EYI's review, nothing has come to our attention to cause us to believe that, in all material respects:

   a. the hypothetical assumptions are not consistent with the purpose of the Cash Flow Forecast;

   b. as at the date of this Report, the probable assumptions developed by management are not suitably supported and consistent with the plans of Terrace Bay or do not provide a reasonable basis for the Cash Flow Forecast, given the hypothetical assumptions; or

   c. the Cash Flow Forecast does not reflect the probable and hypothetical Assumptions.

28. As described in the Terms of Reference above, since the Cash Flow Forecast is based on assumptions regarding future events, actual results will vary from the information presented, even if the hypothetical assumptions occur, and the variations may be material. Accordingly, EYI expresses no assurance as to whether the Cash Flow Forecast will be achieved. In addition, EYI expresses no opinion or other form of assurance with respect to the accuracy of financial information presented in the Cash Flow Forecast, or relied upon by EYI in preparing this Report.

29. The Cash Flow Forecast has been prepared solely for the purpose described above, and readers are cautioned that it may not be appropriate for other purposes.

30. The Cash Flow Forecast projects that the Applicant will have sufficient liquidity to operate during the CCAA proceedings, assuming a buyer for the mill can be found in accordance with timelines detailed in the Sales Process.

31. Terrace Bay's cash balance at the commencement of its CCAA proceedings is approximately $2.0 million, as detailed on the Cash Flow Forecast.

ADMINISTRATION AND DIRECTORS' CHARGES

32. The proposed Initial Order provides for an unlimited charge in favour of the officers and directors of Terrace Bay. EYI has been advised that, while the director intends to discharge his duties in accordance with all relevant laws, the purpose of this charge (the "**Director's Charge**") is to indemnify the director of Terrace Bay in the event that relevant insurance policies are not sufficient to satisfy claims that he, in his capacity as director, may be liable for.

33. Terrace Bay is seeking a charge in favour of certain professionals that may be engaged during the course of the CCAA Proceedings. Such professionals include the proposed Monitor, its counsel and counsel to Terrace Bay. The amount of the proposed charge (the "**Administration Charge**") is $750,000.

34. EYI is of the view that both the Director's Charge and the Administration Charge are reasonable and appropriate in these circumstances.

CONCLUSION

35. EYI is of the view that the Sales Process, as described above, will allow a thorough canvassing of the market with a view to identifying parties to purchase the assets to be marketed by Terrace Bay.

36. EYI is further of the view that the charges sought by Terrace Bay, namely the Director's Charge and the Administration Charge, are also appropriate.

All of which is respectfully submitted this 24th day of January, 2012.

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

Per:

Alex Morrison
Senior Vice President

APPENDIX "A"

15-WEEK CASH FLOW

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Applicant

REPORT ON CASH FLOW STATEMENT
(Section 10(2)(b) of the *Companies' Creditors Arrangement Act* ("CCAA"))

Terrace Bay Pulp Inc. (the "Applicant") has prepared the attached statement of projected cash flow of the Applicant as of January 22, 2012 ("**Cash Flow Statement**") consisting of a 15 week cash flow for the period January 22, 2012 to May 5, 2012. The Applicant developed the assumptions contained in the Notes to the Cash Flow Statement (the "**Notes**"). The purpose of the Cash Flow Statement is to determine the liquidity requirements for the Applicant during the CCAA proceedings.

The hypothetical assumptions are reasonable and consistent with the purpose of the projections described herein, and the probable assumptions are suitably supported and consistent with the plans of the Applicant and provide a reasonable basis for the projections. All such assumptions are disclosed in the Notes.

Since the projections are based on assumptions regarding future events, actual results will vary from the information presented, and the variations may be material.

The projections have been prepared solely for the purpose described herein, using the probable and hypothetical assumptions set out in the Notes. Consequently, readers are cautioned that the Cash Flow Statement may not be appropriate for other purposes.

Dated: January 24, 2012

TERRACE BAY PULP INC.
Per: Wolf Gericke

12534864.1

Terrace Bay Pulp Inc.
CCAA Cash Flows

Week	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Beginning of week	22-Jan	29-Jan	05-Feb	12-Feb	19-Feb	26-Feb	04-Mar	11-Mar	18-Mar
End of week	28-Jan	04-Feb	11-Feb	18-Feb	25-Feb	03-Mar	10-Mar	17-Mar	24-Mar
Bank balance, beginning of week	**1,956,282**	**2,390,449**	**2,717,368**	**2,199,328**	**2,895,979**	**3,646,947**	**4,279,275**	**5,260,888**	**5,125,189**
Blocked account receipts:									
Customer Receipts[1]	1,446,215	1,255,391	770,605	1,010,153	1,025,969	1,012,328	461,613	154,301	-
Funding received from GTP[2]	-	-	-	4,626,099	641,955	-	-	-	-
Other	-	-	-	-	-	-	1,000,000	-	1,000,000
Total cash receipts from all sources	1,446,215	1,255,391	770,605	5,636,252	1,667,924	1,012,328	1,461,613	154,301	1,000,000
Expected cash outlays during the week:									
Selling expenses (freight, commissions, brokerage)[3]	(172,048)	(173,472)	(58,645)	(23,503)	-	-	-	-	-
Salaries and wages[4]	(125,000)	-	(50,000)	(75,000)	(50,000)	(75,000)	(50,000)	(75,000)	(50,000)
Payroll withholdings[4]	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)
Benefits and pension[4]	-	(80,000)	-	(40,000)	-	(40,000)	-	(40,000)	-
WSIB[4]	(80,000)	-	-	-	(20,000)	-	-	-	-
Operations[5]	(270,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)
Utilities, Fuel and Chemicals[5]	(10,000)	(10,000)	(985,000)	(10,000)	(10,000)	(10,000)	(235,000)	(10,000)	(760,000)
Restructuring Cost[6]	(230,000)	(40,000)	(40,000)	(40,000)	(40,000)	(130,000)	(40,000)	(40,000)	(40,000)
Insurance[7]	-	(500,000)	-	-	-	-	-	-	-
Property taxes[8]	-	-	-	-	-	-	-	-	-
Disbursements regarding GTP[2]	-	-	-	(4,626,099)	(641,955)	-	-	-	-
Blow Tank repairs[9]	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	-
Total cash outlays:	(1,012,048)	(928,472)	(1,288,645)	(4,939,602)	(916,955)	(380,000)	(480,000)	(290,000)	(930,000)
Bank balance, end of week	**2,390,449**	**2,717,368**	**2,199,328**	**2,895,979**	**3,646,947**	**4,279,275**	**5,260,888**	**5,125,189**	**5,195,189**

Notes to Cash Flow Forecast

1. Customer receipts are forecast based on average due dates for customer invoices and modified, as necessary, when known issues arise.
2. Funding for Terrace Bay Pulp's Green Transformation Project ("GTP") is received from Natural Resources Canada once they have approved the relevant invoices. It is assumed that any amounts received pursuant to this program will be paid out to the contractors and employees performing the work.
3. Selling expenses include amounts paid to Terrace Bay Pulp's sales agent based on forecast shipments of pulp to customers.
4. Salaries, wages, benefits and the related withholdings are forecast based on staff levels required to keep the mill warm and secure.
5. Operations and Utilities, Fuel and Chemicals are forecast on the assumption that production at the mill will remain idled during the CCAA proceedings.
6. Restructuring Costs are those forecast to be incurred as a result of the current CCAA proceedings.
7. Insurance includes amount to ensure that adequate coverage is maintained through the CCAA proceedings.
8. Property Taxes represent amounts for municipal taxes due to the Town of Terrace Bay.
9. Blow Tank Repairs represent costs to stabilise the damaged are and repair the damaged equipment up to the limit of Terrace Bay's policy deductible.

Terrace Bay Pulp Inc.
CCAA Cash Flows

Week	10	**11**	**12**	**13**	**14**	**15**
Beginning of week	25-Mar	01-Apr	08-Apr	15-Apr	22-Apr	29-Apr
End of week	31-Mar	07-Apr	14-Apr	21-Apr	28-Apr	05-May
Bank balance, beginning of week	**5,195,189**	**3,766,189**	**3,586,189**	**3,146,189**	**2,966,189**	**1,231,189**
Blocked account receipts:						
Customer Receipts[1]	-	-	-	-	-	-
Funding received from GTP[2]	3,746,370	-	-	-	3,141,320	-
Other	(500,000)	-	-	-	(1,500,000)	-
Total cash receipts from all sources	3,246,370	-	-	-	1,641,320	-
Expected cash outlays during the week:						
Selling expenses (freight, commissions, brokerage)[3]	-	-	-	-	-	-
Salaries and wages[4]	(75,000)	(50,000)	(75,000)	(50,000)	(75,000)	(50,000)
Payroll withholdings[4]	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)
Benefits and pension[4]	(40,000)	-	(40,000)	-	(40,000)	-
WSIB[4]	(20,000)	-	-	-	(20,000)	-
Operations[5]	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)
Utilities, Fuel and Chemicals[5]	(10,000)	(10,000)	(235,000)	(10,000)	(10,000)	(760,000)
Restructuring Cost[6]	(130,000)	(40,000)	(40,000)	(40,000)	(40,000)	(130,000)
Insurance[7]	-	-	-	-	-	(167,000)
Property taxes[8]	(604,000)	-	-	-	-	-
Disbursements regarding GTP[2]	(3,746,370)	-	-	-	(3,141,320)	-
Blow Tank repairs[9]	-	-	-	-	-	-
Total cash outlays:	(4,675,370)	(180,000)	(440,000)	(180,000)	(3,376,320)	(1,187,000)
Bank balance, end of week	**3,766,189**	**3,586,189**	**3,146,189**	**2,966,189**	**1,231,189**	**44,189**