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.

SECOND REPORT OF THE MONITOR
DATED FEBRUARY 15, 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 these proceedings (the "**CCAA Proceedings**"). The Initial Order provided for a stay of proceedings through February 24, 2012 (the "**Stay Period**").

PURPOSE

2. The purpose of this second report of the Monitor (the "**Second Report**") is to update the Court in respect of the following:

    a. The Applicant's motion requesting the amendment of the Initial Order to permit those parties who have registered construction lien claims under the *Construction Lien Act* (the "**CLA**") to commence actions in respect of such claims in accordance with the CLA to preserve the time limitations provided for in the CLA, but subject to the stay of proceedings provided by the Initial Order applying to stay any further proceedings against Terrace Bay in respect of those actions;

    b. The status of Terrace Bay's insurance coverage;

c. The status of discussions with Natural Resources Canada ("**NRC**") in respect of the GTP Projects (as defined herein);

d. Terrace Bay's actual cash flows from January 25, 2012 to February 4, 2012 and its revised cash flow forecast;

e. The status of the sales process approved by the Initial Order to identify a purchaser of Terrace Bay's mill assets (the "**Sales Process**"); and

f. The Applicant's motion to amend and restate the Initial Order to reflect the relief granted in the Supplemental Initial Order of Mr. Justice Morawetz dated February 2, 2012 (the "**Supplemental Initial Order**") and the Second Supplemental Initial Order of Mr. Justice Morawetz dated February 7, 2012 (the "**Second Supplemental Initial Order**") and to extend the Stay Period to April 27, 2012.

TERMS OF REFERENCE

3. In preparing this Second 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 Second Report. Some of the information referred to in this Second 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 Second 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.

UPDATE ON STATUS OF LIEN CLAIMS

4. Terrace Bay's motion materials filed with respect to the motion to obtain the Supplemental Initial Order contained information regarding lien claimants that have registered liens under the CLA in respect of construction work done on Terrace Bay's property. As noted in the Affidavit of Wolfgang Gericke sworn February 15, 2012 filed in support of this motion by Terrace Bay (the "**Second Gericke Affidavit**"), a number of the Construction Lien Claimants (as defined in the Supplemental Initial Order) who have already registered liens against the Applicant's real property have requested permission to commence actions against Terrace Bay for the purposes of perfecting their lien claims under the CLA.

5. In order to avoid a number of court motions and/or written agreements to lift the stay on a case by case basis, Terrace Bay seeks an amendment to the stay provisions of the Initial Order to permit those parties who have registered construction lien claims under the CLA to commence actions in respect of such claims within the time limitations provided under the CLA. It is proposed that such actions would otherwise be subject to the stay of proceedings provided by the Initial Order.

6. In order to keep track of the construction lien actions that are issued, Terrace Bay is also seeking an order that any action commenced by a Construction Lien Claimant on or after February 16, 2012 be served on Terrace Bay and the Monitor within 5 days of its issuance.

INSURANCE MATTERS

7. As described in the Second Gericke Affidavit, prior to commencing these CCAA Proceedings, Terrace Bay maintained both general liability insurance ("**General Liability Insurance**"), and property, boiler and machinery insurance ("**Property Insurance**") in connection with the mill. The policy for the Property Insurance expired on January 31, 2012. As set forth in the Second Gericke Affidavit, as well as the affidavit of Wolfgang Gericke sworn on January 24, 2012 (the "**First Gericke**

Affidavit"), Terrace Bay's insurer was not willing to renew the Property Insurance policy.

8. As further described in the Second Gericke Affidavit, Terrace Bay has made efforts to obtain replacement Property Insurance (the "**Replacement Property Insurance**"). Despite its efforts, however, Terrace Bay was only able to secure a quote for Replacement Property Insurance coverage (although excluding business interruption and boiler and machinery coverage) with a limit of $50 million, subject to a deductible of $10 million and on a 12 month subscription basis. The annual premium contemplated for such coverage was approximately $2.2 million, subject to a 50% minimum retained premium, which premium was due, in full, on commencement of the coverage. The policy was also subject to a minimum term of 6 months and no assurances could be provided by the insurance broker that the balance of the premium, if the policy was cancelled, would be provided on a timely basis.

9. In light of the high premium cost, exclusions from coverage, high deductible and because it is not currently operating and needs to conserve its cash resources, Terrace Bay has re-evaluated its need to obtain the Replacement Property Insurance and has determined that it will not obtain coverage of this nature.

10. Terrace Bay has confirmed that it continues to maintain general liability insurance, which will remain in place through May 31, 2012.

11. The Monitor discussed the status of the Replacement Property Insurance with the Province of Ontario (the "**Province**"), as a secured creditor of Terrace Bay, and understands that the Province does not object to the decision of Terrace Bay regarding the Replacement Property Insurance.

GREEN TRANSFORMATION PROGRAM PROJECTS

12. As noted in the First and Second Gericke Affidavits, prior to commencing these CCAA Proceedings, Terrace Bay was a participant in the Green Transformation Program (the "**GTP**") which is administered by NRC. The GTP provides non-repayable grants for

certain projects that meet defined criteria. Terrace Bay was participating in 2 projects pursuant to the GTP (the "**GTP Projects**").

13. Terrace Bay, prior to the commencement of these CCAA Proceedings, received funding in the amount of approximately $420,000 pursuant to the GTP Projects. As described in the Second Gericke Affidavit, on January 30, 2012, Terrace Bay sought and obtained an order (the "**GTP Order**") authorizing it to continue the GTP Projects, and requiring Terrace Bay to pay all obligations incurred by it in connection with the GTP Projects to any contractor or supplier from funds received from NRC for such obligations, which funds were deemed to be held in trust for such contractors, and not be available to other creditors.

14. The GTP Order also required Terrace Bay to seek confirmation from NRC that all invoices and receipts properly submitted after the date of the Initial Order in accordance with the agreements entered into by Terrace Bay with NRC would be funded by NRC prior to Terrace Bay re-commencing work in relation to the GTP Projects. Terrace Bay is continuing to work out issues relating to the GTP Projects, including the funding of obligations relating to the GTP Projects that are not funded by NRC. In the interim, work on the GTP Projects has not yet recommenced and it is not clear that these projects can be fully completed by March 31, 2012. As described in the Second Gericke Affidavit, pending its evaluation of whether it will be in a position to recommence the GTP Projects, Terrace Bay has not yet remitted payment of the amount of $420,000 owing to contractors in relation to work on the GTP Projects prior to November 2011.

UPDATE ON ACTUAL CASH FLOWS AND THE REVISED CASH FLOW FORECAST

15. Appendix "A" to this Second Report contains actual cash flow results for the period from January 25, 2012 to February 4, 2012 (the "**Reporting Period**").

16. The following is a summary of significant variances from the cash flow forecast that was filed with the Court at the commencement of the CCAA Proceedings, a copy of which was included as an appendix to the First Gericke Affidavit (the "**Cash Flow Forecast**"):

a. Total cash receipts for the Reporting Period were approximately $990,000 lower than projected in the Cash Flow Forecast. This is due to the timing of customer receipts and is offset by a higher than forecast accounts receivable balance than contemplated by the Cash Flow Forecast.

b. Selling expenses were approximately $115,000 lower than forecast in the Cash Flow Forecast due to the timing of payments to Terrace Bay's sales agent.

c. Costs related to operations were approximately $296,000 lower than forecast due to the timing of repairs to the boiler at Terrace Bay. This variance is due to timing and has been reflected in the updated cash flow forecast included as Appendix "B" to this Second Report (the "**Revised Cash Flow Forecast**").

d. Restructuring costs are lower than forecast primarily due to the timing of invoice receipt from various professional service firms. The Revised Cash Flow Forecast reflects this timing difference.

e. As noted above, Terrace Bay did not secure Replacement Property Insurance. As such, the insurance payment included in the Cash Flow Forecast was not made.

17. The Revised Cash Flow Forecast, which is attached as Appendix "B" to this Second Report, has been prepared by Terrace Bay with assistance from the Monitor.

18. In the Revised Cash Flow Forecast the closing cash at April 28, 2012 is projected to be approximately $1.4 million. As such, the Applicant is forecast to have sufficient liquidity through the extension of Stay Period being sought.

UPDATE ON THE SALES PROCESS

19. The Initial Order approved a Sales Process for Terrace Bay to find a buyer for certain of its assets and operations.

20. To date, in accordance with the provisions of the Sales Process, the Monitor has been assisting Terrace Bay in its efforts to find a purchaser for the mill assets. Such activities have included:

a. Identifying parties that may be interested in purchasing the mill and related assets. Such potential purchasers include strategic buyers, financial buyers, liquidators and decommissioning firms;

b. Sending teaser documents to potential purchasers. Included with the teaser document is a summary of the Sales Process and a confidentiality agreement necessary to gain access to further due diligence materials;

c. Providing interested parties with a copy of Terrace Bay's confidential information memorandum (the "**CIM**") once confidentiality agreements have been signed; and

d. Granting interested parties who have executed a confidentiality agreement access to an electronic data room. The Monitor continues to respond to questions from bidders in respect of such materials.

21. The Monitor is working closely with interested parties who have executed confidentiality agreements. The Monitor expects to receive letters of intent ("**LOIs**") on the February 15, 2012 deadline as set out in the Sales Process. The Monitor will report in greater detail once it has had an opportunity to review the LOIs submitted.

22. Terrace Bay also owns a number of real estate assets in addition to the pulp mill (the "**Real Estate Assets**"), including a nine-hole golf course, undeveloped lakefront land and townhouses in the Terrace Bay community. The Monitor is working with Terrace Bay to develop a sales process to maximize the value of the Real Estate Assets.

EXTENSION OF THE STAY PERIOD

23. As noted above, the Stay Period, absent an extension, is due to expire on February 24, 2012.

24. The Applicant, as noted in its filing materials, requires an extension of the Stay Period to April 27, 2011 to:

a. Continue the Sales Process;

b. Develop a process for the sale of the Real Estate Assets;

c. Complete the repairs required to the blow tank and otherwise stabilize the mill;

d. Determine whether it can recommence the GTP Projects; and

e. Continue to convert working capital assets into cash to fund the Sales Process.

RECOMMENDATION

25. The Monitor is of the view that amending the Initial Order to permit persons who have registered construction lien claims under the CLA to commence actions in respect of such claims in accordance with the time limitations provided for under the CLA, on the basis that such actions will be otherwise stayed, and to require timely service of such actions as is being requested by Terrace Bay, is appropriate.

26. The Monitor is of the view that extending the Stay Period to April 27, 2012 is appropriate as:

a. An extension of the Stay Period to and including April 27, 2012 will allow Terrace Bay to continue with the Sales Process and to develop a sales process to dispose of the Real Estate Assets;

b. The Revised Cash Flow Forecast indicates that Terrace Bay should have sufficient funding during the proposed stay extension of the Stay Period; and

c. The extension of the Stay Period will allow Terrace Bay stability to continue the activities reported on in the Second Gericke Affidavit.

All of which is respectfully submitted this 15th day of February, 2012.

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

Per:

Alex Morrison
Senior Vice President

APPENDIX “A”
ACTUAL RECIEPTS AND DISBURSEMENTS

Terrace Bay Pulp Inc.
CCAA Cash Flows

	Actuals			Budget			Variance		
Beginning of week	25-Jan-12	29-Jan-12		25-Jan-12	29-Jan-12		25-Jan-12	29-Jan-12	
End of week	28-Jan-12	04-Feb-12	Total	28-Jan-12	04-Feb-12	Total	28-Jan-12	04-Feb-12	Total
Bank balance, beginning of week	**2,784,475**	**3,017,515**	**2,784,475**	**1,956,282**	**2,390,449**	**1,956,282**	**828,193**	**627,066**	**828,193**
Receipts									
Customer Receipts	551,020	1,158,163	1,709,184	1,446,215	1,255,391	2,701,606	(895,195)	(97,228)	(992,423)
Funding received from GTP	-	-	-	-	-	-	-	-	-
Other	-	1,879	1,879	-	-	-	-	1,879	1,879
Total cash receipts from all sources	551,020	1,160,042	1,711,063	1,446,215	1,255,391	2,701,606	(895,195)	(95,349)	(990,544)
Disbursements									
Selling expenses (freight, commissions, brokerage)	(120,842)	(109,971)	(230,813)	(172,048)	(173,472)	(345,520)	51,206	63,501	114,707
Salaries and wages	(92,811)	(120)	(92,931)	(125,000)	-	(125,000)	32,189	(120)	32,069
Payroll withholdings	-	(51,017)	(51,017)	(50,000)	(20,000)	(70,000)	50,000	(31,017)	18,983
Benefits and pension	-	(84,474)	(84,474)	-	(80,000)	(80,000)	-	(4,474)	(4,474)
WSIB	-	(78,974)	(78,974)	(80,000)	-	(80,000)	80,000	(78,974)	1,026
Operations	(1,119)	(2,549)	(3,667)	(270,000)	(30,000)	(300,000)	268,881	27,451	296,333
Utilities, Fuel and Chemicals	-	-	-	(10,000)	(10,000)	(20,000)	10,000	10,000	20,000
Restructuring Cost	(103,208)	(20,000)	(123,208)	(230,000)	(40,000)	(270,000)	126,792	20,000	146,792
Insurance	-	-	-	-	(500,000)	(500,000)	-	500,000	500,000
Property taxes	-	-	-	-	-	-	-	-	-
Disbursements regarding GTP	-	-	-	-	-	-	-	-	-
Blow Tank repairs	-	(19,381)	(19,381)	(75,000)	(75,000)	(150,000)	75,000	55,619	130,619
Total disbursements	(317,980)	(366,486)	(684,465)	(1,012,048)	(928,472)	(1,940,520)	694,068	561,987	1,256,055
Bank balance, end of week	**3,017,515**	**3,811,072**	**3,811,072**	**2,390,449**	**2,717,368**	**2,717,368**	**627,066**	**1,093,704**	**1,093,704**

APPENDIX "B"
REVISED CASH FLOW FORECAST

Terrace Bay Pulp Inc.
CCAA Cash Flows

Week	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Beginning of week	05-Feb	12-Feb	19-Feb	26-Feb	04-Mar	11-Mar	18-Mar	25-Mar	01-Apr	08-Apr
End of week	11-Feb	18-Feb	25-Feb	03-Mar	10-Mar	17-Mar	24-Mar	31-Mar	07-Apr	14-Apr
Bank balance, beginning of week	**3,811,072**	**2,981,973**	**3,115,106**	**3,493,837**	**4,229,462**	**4,726,487**	**5,265,595**	**4,290,595**	**3,361,595**	**3,136,595**
Receipts										
Customer Receipts[1]	795,839	1,180,583	698,731	1,115,625	1,022,025	879,108	-	-	-	-
Funding received from GTP[2]	-	-	4,626,099	-	641,955	-	-	3,746,370	-	-
Other	-	-	-	-	-	-	-	-	-	-
Total cash receipts from all sources	795,839	1,180,583	5,324,830	1,115,625	1,663,980	879,108	-	3,746,370	-	-
Disbursements										
Selling expenses (freight, commissions, brokerage)[3]	(83,938)	(62,450)	-	-	-	-	-	-	-	-
Salaries and wages[4]	(41,000)	(75,000)	(45,000)	(75,000)	(45,000)	(75,000)	(45,000)	(75,000)	(45,000)	(75,000)
Payroll withholdings[4]	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)	(50,000)	(20,000)
Benefits and pension[4]	-	(40,000)	-	(40,000)	-	(40,000)	-	(40,000)	-	(40,000)
WSIB[4]	-	-	(20,000)	-	-	-	-	(20,000)	-	-
Operations[5]	(265,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)
Utilities, Fuel and Chemicals[5]	(830,000)	(235,000)	(10,000)	(10,000)	(235,000)	(10,000)	(760,000)	(10,000)	(10,000)	(235,000)
Restructuring Cost[6]	(280,000)	(90,000)	(90,000)	(130,000)	(90,000)	(90,000)	(90,000)	(130,000)	(90,000)	(90,000)
Insurance[7]	-	-	-	-	-	-	-	-	-	-
Property taxes[8]	-	-	-	-	-	-	-	(604,000)	-	-
Disbursements regarding GTP[2]	-	(420,000)	(4,626,099)	-	(641,955)	-	-	(3,746,370)	-	-
Blow Tank repairs[9]	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	-	-	-	-
Total cash outlays:	(1,624,938)	(1,047,450)	(4,946,099)	(380,000)	(1,166,955)	(340,000)	(975,000)	(4,675,370)	(225,000)	(490,000)
Bank balance, end of week	**2,981,973**	**3,115,106**	**3,493,837**	**4,229,462**	**4,726,487**	**5,265,595**	**4,290,595**	**3,361,595**	**3,136,595**	**2,646,595**

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 ("NRC") once they have approved the relevant invoices. Any amounts received pursuant to this program are deemed to be trust funds pursuant to the Order of Mr. Justice Morawetz dated January 30, 2012 (the "GTP Order"), and such funds will be paid out to the contracts and employees performing the work on the project, if received by the Applicant. At this time, the requirements contained in the GTP Order for the recommencement of the project have not been met. The Applicant continues to pursue the required confirmations needed from NRC and agreements with the contractors and suppliers as described in the affidavit of Wolf Gericke sworn February 15, 2012.
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. Terrace Bay will not be obtaining property insurance during 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 area and repair the damaged equipment up to the limit of Terrace Bay's policy deductible.

Terrace Bay Pulp Inc.
CCAA Cash Flows

Week	11	12
Beginning of week	15-Apr	22-Apr
End of week	21-Apr	28-Apr
Bank balance, beginning of week	**2,646,595**	**2,421,595**
Receipts		
Customer Receipts[1]	-	-
Funding received from GTP[2]	-	1,222,967
Other	-	-
Total cash receipts from all sources	-	1,222,967
Disbursements		
Selling expenses (freight, commissions, brokerage)[3]	-	-
Salaries and wages[4]	(45,000)	(75,000)
Payroll withholdings[4]	(50,000)	(20,000)
Benefits and pension[4]	-	(40,000)
WSIB[4]	-	(20,000)
Operations[5]	(30,000)	(30,000)
Utilities, Fuel and Chemicals[5]	(10,000)	(10,000)
Restructuring Cost[6]	(90,000)	(90,000)
Insurance[7]	-	(167,000)
Property taxes[8]	-	(604,000)
Disbursements regarding GTP[2]	-	(1,222,967)
Blow Tank repairs[9]	-	-
Total cash outlays:	(225,000)	(2,278,967)
Bank balance, end of week	**2,421,595**	**1,365,595**