

Newfoundland and Labrador Hydro



**A strengthened capital structure
to enable expanded mandate**



February 22, 2006



Purpose and Agenda

- Purpose

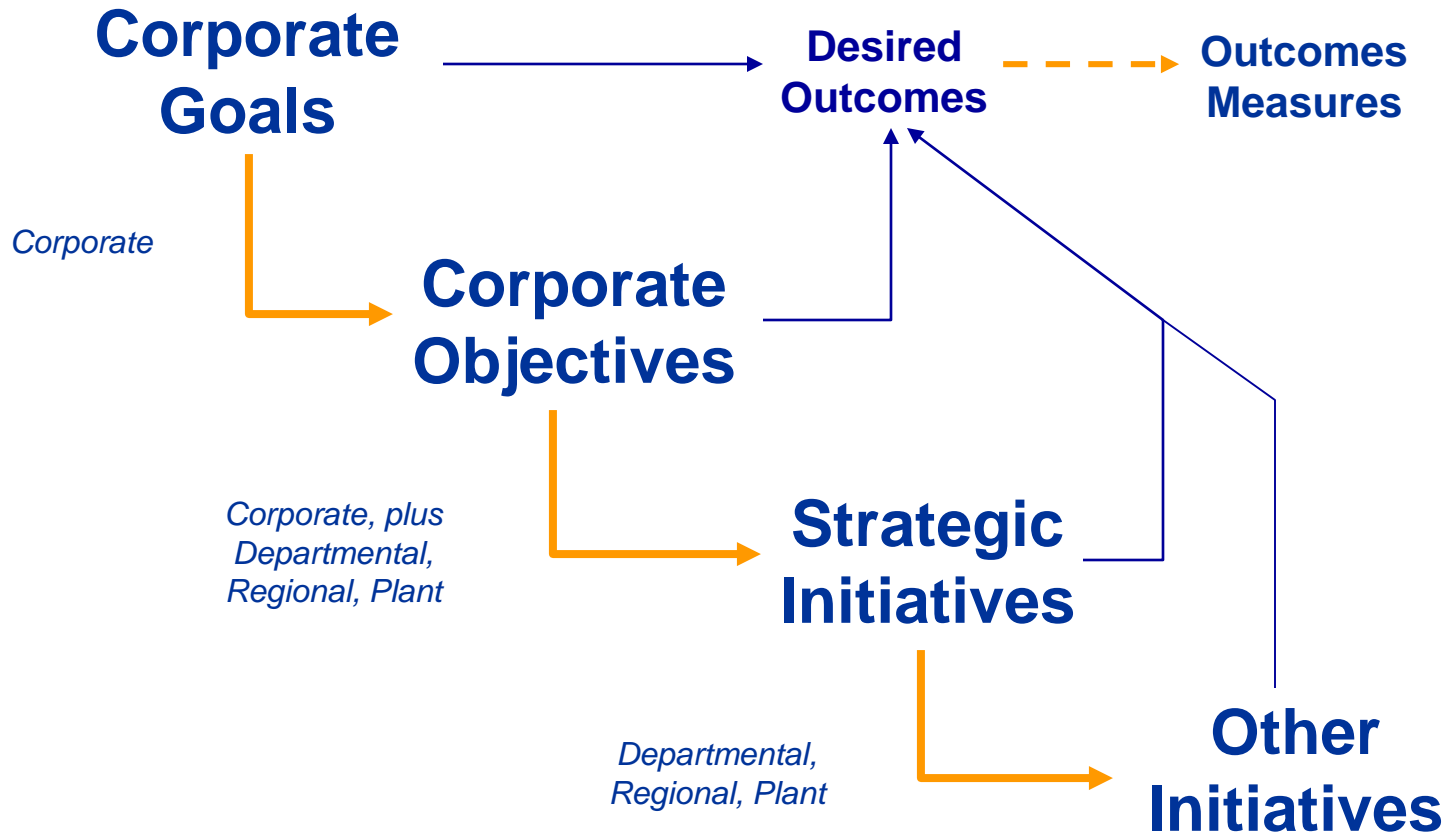
- ✘ Seek shareholder alignment regarding Hydro's recommended financial structure
- ✘ Seek concurrence re dividend policy and financing for growth

- Agenda

- ✘ Where this issue fits in Hydro's long term plans
- ✘ How does this add value to the shareholder
- ✘ Why this is necessary for Hydro's success
- ✘ Suggested Way Forward
- ✘ Recommendation



Process & Terminology



Hydro's Goals and Objectives



- Safety
 - To be a safety leader
- Environmental
 - To be an environmental leader
- Financial and Governance
 - To strengthen our financial and governance structures to enable growth
- Growth
 - To grow a diversified and viable energy business
- Reliability
 - Trough Operational excellence, to provide exceptional value to all consumers of our energy
- Lower Churchill
 - To achieve sanction for the Lower Churchill Project
- People
 - To ensure a highly skilled and motivated team of employees who are strongly committed to Hydro's success and future direction
- Corporate Citizen
 - To be a valued corporate citizen in Newfoundland and Labrador

Adding value to the Shareholder



- Our intention is to provide returns to our shareholder, the Province, which are competitive with the private sector
 - ⌘ Investment in NLH over time will return substantially more to the Province than other forms of available investment/debt pay down
 - ⌘ Added benefit of expanding the provincial economy
 - ⌘ Retains profits and benefits in the Province



The focus of Hydro's Goal 3

- In order to maximize probability of success in achieving Hydro's mandate, it is essential for Hydro's capital and governance structures to be organized to enable it, as a crown owned entity, to be competitive with private enterprises in the context of business focused decision making and operating processes
 - Access to capital to enable growth
 - Strengthen corp.governance to support growth



Why Necessary

- Hydro's successful growth will enhance share value to the benefit of all people of the Province
- Government's return on their equity investment in Hydro greater than related borrowing cost thereby adding value
- New expansion debt would be considered as standalone and not a burden to the Province's debt load
- Restoration of Hydro's borrowing room
- Equity infusion accounted for as a government asset



Why Necessary cont'd

- Timely decision-making is imperative in a competitive environment
- Enhances Hydro's competitive edge by enforcing private sector discipline
- Place Hydro on an equal footing with marketplace competitors and thereby thwart charges of unfair competition
- Support Hydro's request to regulator for a rate of return on its equity that is consistent with that of an Investor Owned Utility (currently only receiving a return equivalent to the Province's marginal cost of debt)
- Larger equity base will help reduce hearing frequency by increasing dollar margin



Pillars for Success

1. The establishment of a healthy capital structure for Hydro
 - Benchmark – Standalone investor owned utility (IOU)
2. A structured approach to the ongoing funding of Hydro's growth through a clearly defined decision-gate process and integration with the Province's financial planning process
3. A shareholder relationship that is focused on value of the company



Pillar 1

Establishing a Healthy Capital Structure



Constraints

- Hydro's current financial structure is not conducive to business growth:
 - Legislated borrowing limit, < \$200 M remaining
 - Short term debt limited to \$300 M
 - A balance sheet that does not permit further borrowing in the absence of a government guarantee
 - Inability to access public equity markets.



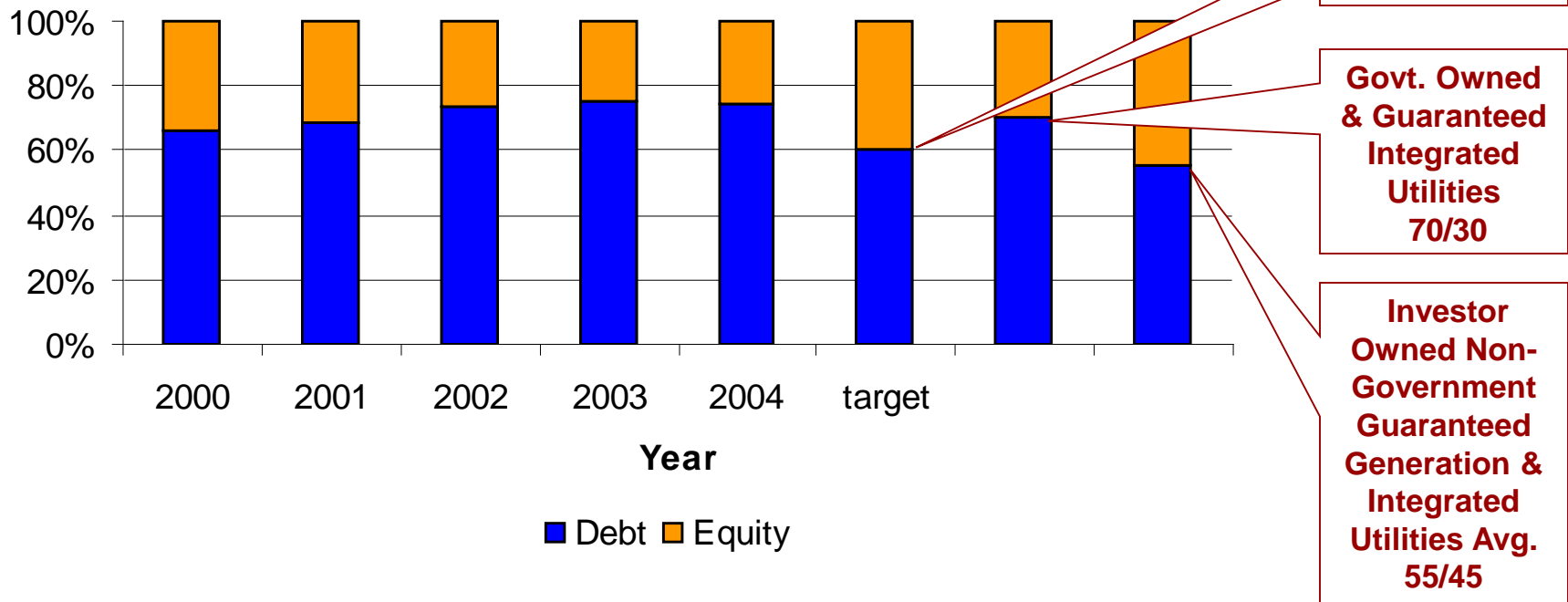
Establish Healthy Capital Structure

- Restructuring of Hydro's capital structure towards 60/40 Debt to Equity:
 - Suspension of dividend payouts
 - Additional equity infusion would speed progress



Capital Structure

NLH Debt to Equity Ratio





Overcoming Constraints – Restructuring

2006 Targets

- Confirm our understanding of parameters necessary to secure an investment grade rating for new Hydro debt in the absence of a government debt guarantee
- Confirm our understanding of implications for the Province's credit rating and potential rate impacts
- Prepare capital restructuring plan
- Receive Board of Directors & Government approval
- Establish decision gate process for equity infusion

2007/8 Targets

- Implement restructure plan
 - Establish healthy capital structure



Pillar 2

Structured Approach to Funding Growth



Preservation of Capital Structure

- To preserve Hydro's capital structure, future expansion must be financed by both debt and equity
- Decision gate process is required leading to approved equity investment levels on an annual basis and integrated with Government's budgetary process
 - Compile portfolio of planned Hydro expansion plans that meet pre-determined hurdles
 - Equity implications of Hydro's expansion plans should be incorporated into the longer term financial plans of Province
 - Hydro's capital expansion plans and related equity investment requirements must be communicated to Government in advance of each budget year and integrated into Provincial budget process



Pillar 3

Shareholder Relationship



Relationship Principles

- Hydro's governance structure must support effective and timely decision-making by Management in a competitive environment
- Adoption of Investor Owned Utility standards governance standards
- An shareholder relations function that ensures ongoing and meaningful communication with the shareholder
- A focus accountability in Government to person/s who are responsible for the interests of the Province as a shareholder



Competitive Footing

- Elimination of Provincial guarantee from new Hydro debt issuance upon achievement of investment grade rating
- Hydro to make payments to the Province in lieu of income tax
- Hydro to make payments to the Province for water rentals
- The Province accepts responsibility for the rural subsidy

Intent is neutral impact on overall government take from regulated operations.



Recommendation

- Restructure Hydro's capital structure towards 60/40 Debt to Equity:
 - Suspension of dividend payouts
 - Additional equity infusion to speed progress - \$~100 million

Note: Acceptance by the rating agencies that a 60/40 debt equity split in Hydro on a corporate basis is adequate to support a standalone investment grade credit rating is yet to be tested.