Lower Churchill Project

nalcor energy
LOWER CHURCHILL PROJECT

Guidelines for Credit Worthiness Verification

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1.0 Purpose

The purpose of this document is to define the process by which Nalcor Energy Corporate Treasury will complete credit worthiness verification of Bidders who are bidding on the supply of goods and/or services to the Lower Churchill Project (LCP). This process will be used in LCP's supply chain management process.

2.0 Scope

This guideline shall apply to all Bidders who meet the requirements for the technical evaluation of the procurement or contract being issued. Financial evaluation will occur for Bidders participating in bids in excess of $10 Million in estimated value or whose risk assessment warrants, as further outlined in Section 7. This does not preclude Bidders participating in a bid process of a lesser value from being evaluated.

3.0 Definitions

Bidders – Companies participating in the bid process for the supply of goods and/or services to the LCP.

Budget Holder – Person who has been assigned Responsibility for the completion of aspects of the work scope contained in the Project Component AFE and who is accountable for developing, scheduling, controlling, forecasting and delivering against a particular scope of work. The Budget Holder is also responsible for financial stewardship of funding associated with his/her work scope.

Contract – A legal agreement that binds Nalcor to a Financial Commitment and/or obligation to another party.

Financial Advisors - PricewaterhouseCoopers and/or other financial advisors appointed by Nalcor Energy.

Project Management Team – means NE LCP staff, NE or NLH staff assigned to the Lower Churchill Project and consultants working as part of the integrated project management team.

Turnover – defined as the Bidders ability to generate annual operating revenues equal to or greater than three (3) times the estimated value of the bid package(s).

4.0 Abbreviations and Acronyms

CT	Corporate Treasury
D&B	Dun and Bradstreet
DBRS	Dominion Bond Rating Service
LCP	Lower Churchill Project
LCP-F&A	Finance & Accounting
LCP-SCM	Supply Chain Management
NE	Nalcor Energy
NLH	Newfoundland and Labrador Hydro, a Nalcor Energy company
PMT	Project Management Team
S&P	Standard & Poors

5.0 Reference Documents

LCP-PT-MD-0000-SC-PR-0007-01 - Supply Chain Management - Identify and Select Bidders
LCP-PT-MD-0000-FI-PR-0001-01 - Capital Expenditure Authorization Procedure
LCP-PT-MD-0000-SC-PL-0001-01 - Procurement Management Plan

6.0 Responsibilities

Bidder: Is responsible to provide necessary financial information to effect an evaluation of its financial position, and if successful, for ongoing analysis as required.

SCM: Identifying the need for completion of credit worthiness in accordance with this procedure

CT:

- Completion of Bidder credit worthiness verification review; ownership and maintenance of this process
- Responsible to obtain and evaluate the financial information for all Bidders involved in the provision of materials and services to the LCP as outlined in this document. The final award recommendation and approval will be made in conjunction with the appropriate Budget Holder and LCP-SCM.

7.0 Evaluation Procedure

7.1 General

Project financing, or financial close, is an integral part of the NE Gateway process and the ability to achieve sanction requires that project financing be achievable and in place. An integral part of the risk analysis of the LCP is financing, so lenders will have interest in the LCP's major Bidders financial stability; the ability to provide services as contracted, including management ability, its track record for completion on a timely basis and within budget and absorption of risk.

A major component of this risk assessment will be satisfactory Bidder financial stability and capacity to perform. This will include an evaluation of the Bidders ability to absorb risk, as well as the level of risk the Bidder is able to absorb without diminishing its ability to perform. Identification of the exposure and ability to absorb the risk is important in assessing the exposure to NE and NE's ability to backstop the risk.

In an effort to ensure that Bidders meet a high standard and are financially capable to support the work for which they are qualified, it is necessary to properly evaluate each Bidder to ensure a stable and acceptable financial status exists. The determination of the level at which financial evaluation is required, is a combination of the dollar value of the bid package and the risk associated with that Bidder, both from its ability to supply and the impact of failure to supply, or timely performance, on the LCP as a whole.

Financial evaluation will occur if the risk of failure associated with any Bidder is deemed moderate to high, and/or the value of the bid package is in excess of $10 Million. This does not preclude bid packages of a lesser value being evaluated.

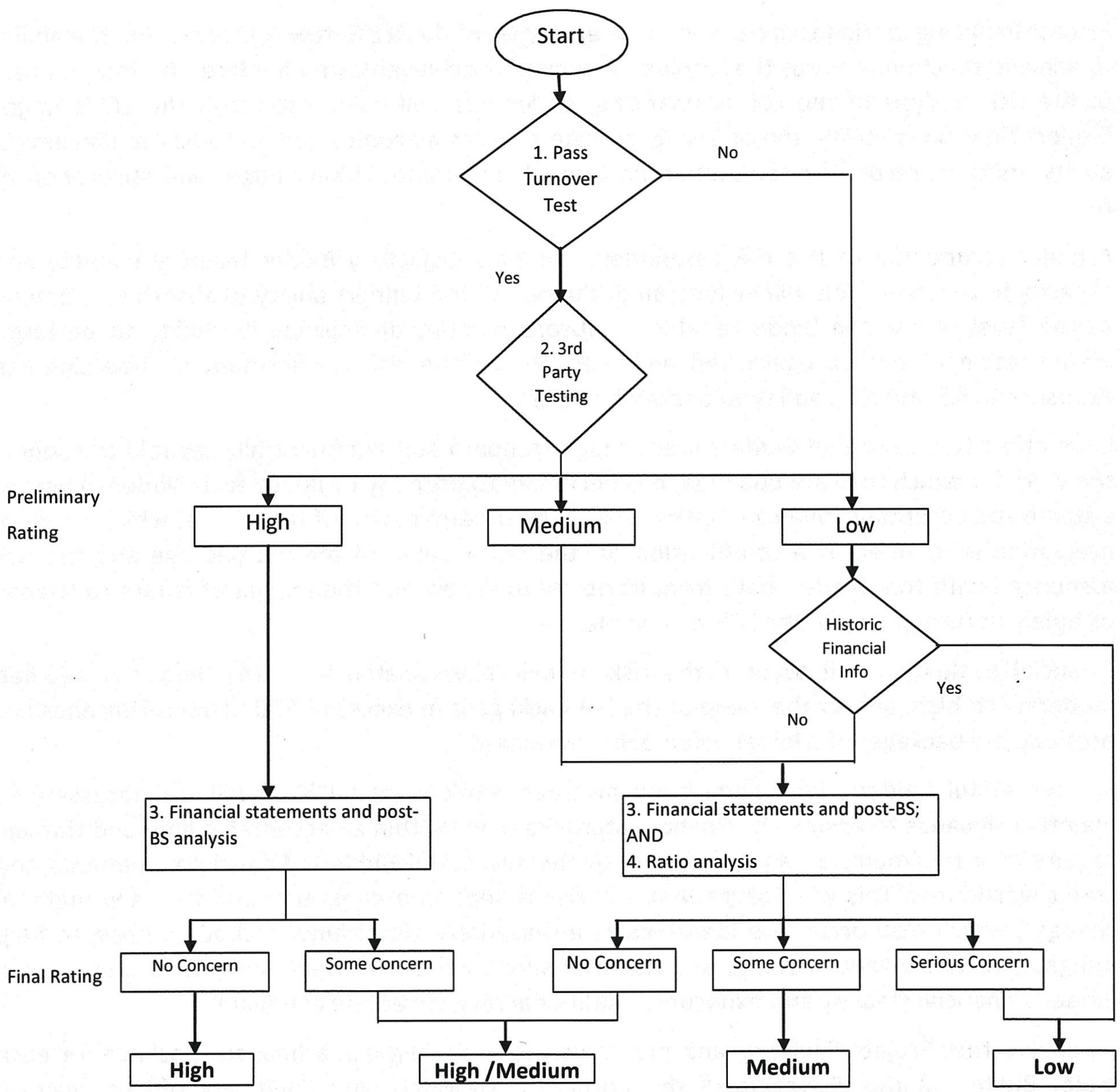
For successful Bidders, who have been awarded work on the LCP, it will be necessary to maintain vigilance to ensure the financial status remains within an acceptable limit and this will require at a minimum, an annual review of the successful Bidder's financial statements and credit worthiness. This will ensure that any risk is kept to a minimum, and that any material changes, which may occur, are identified in a reasonable timeframe, and acted upon to help mitigate, to the extent possible, any risk exposure to the LCP. Depending on the successful Bidder's financial stability and exposures, additional reviews will be conducted.

To ensure that Project financing and risk assessment are aligned, a financial package for each major Bidder, at the discretion of the Corporate Treasurer and Chief Risk officer, may be forwarded to the Financial Advisors for their review and opinions with respect to these Bidders, and to provide suggestions/solutions to mitigate any risks, and/or to bolster the contractual relationship, that are not clearly identified through this procedure.

7.2 Guideline for Credit Worthiness Procedures

The following procedures are sequenced in the order that the activities should be completed, as outlined in Table 1 below.

Table 1 - Decision Tree for Contrator Credit Worthiness Evaluation



Predominant weighting of credit information rests with third party documentation. CT, with assistance from LCP-F&A as required, will perform the service of obtaining this information by establishing contracts with credible third party organizations to provide the necessary information. The credit checks will be obtained in the following order:

1. Perform a financial test on the Bidder's most recent annual report and audited financial statements. This test would be based on "turnover" in respect to a multiple of contract value to assess the Bidder's financial stability.

2. Obtain, review and assess credit documentation available from bonafide credit organizations, e.g. S&P, Moody's, and DBRS.

3. Conduct a search and evaluation of non-publicly traded entities, such as subsidiaries, joint venture arrangements or partnerships, using such tool as Factiva.com and Dunn & Bradstreet. This review would cover, but is not be limited to, debt equity ratios, free cashflow, interest and profitability ratios, lawsuits, insurance and claims; intangibles such as performance in the marketplace, intercompany activities, and work presently contracted – public information not necessarily available for private companies, nor included in annual reports. The inability to obtain sufficient information through these means may require a review and assessment of credit documentation through financial services organizations with the capability to perform such work.

4. Perform a series of financial tests on the Bidder's most recent annual report and audited financial statements. These would include liquidity, leverage, earnings and other tests necessary to provide comfort in the Bidder's financial stability, as found in Attachment 2.

The primary source of evaluation will be information available from third party credit organizations. It is not necessary for all four steps to be completed. When supplied credit documentation is sufficient to make the assessment, no additional steps are required. CT would resort to an analysis of supplier provided audited financial statements using the financial ratios as per Attachment 2 in the event no, or unsatisfactory, information was available.

7.3 Guideline for Credit Worthiness Testing

The principles underlying the approach to a Bidder's financial assessment are based on demonstrating whether or not the Bidder has sufficient financial strength to deliver the goods and services for which it has bid and can absorb the inherent risks associated with that work. Thresholds involved will need to reflect the intended contract strategy to ensure that risks, which will be transferred to the Bidder, and the LCP, have been accurately identified and quantified.

A multi-step approach is recommended where the most important, high level financial strength indicators are assessed first through a series of three tests, with a fourth test added pending results, as necessary.

Test 1 – Turnover Threshold

A turnover threshold test is based upon a multiple of the bid package value, as a proxy for assessing the ability of the Bidder to theoretically generate sufficient revenues from its on-going business to self-finance the work in the delivery stages, above and beyond its normal business demands on revenues earned. A multiple of 3 x contract value will be used as the turnover threshold, where the bid package value is based on LCP's estimates.

A review of the multiple is necessary for each bid package as it may need to be increased where risks transferred to the Bidder are particularly substantial, or decreased where there are a limited number of Bidders capable of bidding; the latter in order to maintain competition. The multiple may be reduced if minimal risks are passed to the Bidder under the terms of the specific bid package, where delivery of the goods and/or services is fully insured or there is a number of Bidders participating in the bid process.

Turnover data should be sourced from the latest audited financial information. Given current market volatility, if the latest audited financial information produces abnormal results, then use of the average of the past three (3) year's turnover will be used. Failure to pass the turnover threshold indicates a Low strength rating. If the Bidder has indicated that they would be able to provide a comprehensive parent company guarantee or bond, the test should be repeated with data from the entity providing this guarantee.

Recognizing that the assessment process may include some newly established companies with no historic financial information available, assessment of financial strength for such entities will result in a relatively low score. In order to provide an opportunity for these companies to be ranked to a maximum of 'medium' on the basis of Test 3 (see below), provided that 'post balance sheet' information indicates sufficient strength, a parallel assessment of management quality and contract quality is necessary and will be important.

Test 2 – Third Party Rating

A third party risk rating will be used to determine a 'preliminary' financial strength rating. The source for such ratings would be S&P, DBRS, Fitch or Moodys, who focus on larger, global companies, and whose ratings reflect outlook as well as current financial strength.

S&P define a business and financial risk profile matrix and allocate ratings corresponding to the different levels of business and financial risks as shown in Table 2 below. This will need to be reviewed for each bid package, as the threshold levels should reflect the bid package value.

Table 2 – S & P Ratings

Business Risk Profile	Financial Risk Profile				
	Minimal	Modest	Intermediate	Aggressive	Highly Leveraged
Excellent	AAA	AA	A	BBB	BB
Strong	AA	A	A-	BBB-	BB-
Satisfactory	A	BBB+	BBB	BB+	B+
Weak	BBB	BBB-	BB+	BB-	B
Vulnerable	BB	B+	B+	B	B-

Entities not rated by S&P, DBRS, Fitch or Moodys are likely rated by (D&B), which covers a greater number of companies and provides greater detail on those at the smaller end of the market.

D&B international ratings provide an assessment of financial strength based on tangible net worth or issued share capital, and a risk indicator, as explained in Tables 3 and 4.

Table 3: D&B Financial Strength Indicators

Risk Indicator	Estimated Financial Strength ($CDN)	Risk Indicator	Estimated Financial Strength ($CDN)
5A	>= $50,000,000	B	>$94,000 <$188,000
4A	>$10,000,000 <$50,000,000	C	>$47,000 >$94,000
3A	>$1,500,000 <$9,999,999	D	>$24,000 <$47,000
2A	>$750,000 <$1,5000,000	E	>$12,000 <$24,000
1A	>$375,000 <$750,000	F	>$6,000 <$12,000
A	>$188,000 <$375,000	G	>$0 <$6,000

Source: www.dnb.ca

(Search for: key-score-ratings-indices/composite credit rating)

Table 4: D&B Risk Indicators

Risk Indicator	Condition	Probability of Failure	Interpretation
1	**Strong**	**Minimal risk** This is assigned to Bidders with undoubted credit standing and financial strength. The risk associated with being a creditor of these companies would be negligible or zero; the company which pays bills promptly and/or takes early discounts.	Proceed with transaction – offer terms required
2	**Good**	**Low risk** This is assigned to financially sound Bidders having no known record of bad payments and paying suppliers quickly. The risk of being associated with being a creditor of these companies would be low and they would be classified as an ordinary trade risk.	Proceed with transaction

3	**Fair**	**Greater than average risk** This would be assigned to Bidders believed to be financially sound but with a history of slow payments or some losses or working capital deficit. The risk associated with being a creditor of these companies is higher and would be classified as potentially slow payers or fair trade risk.	Proceed with transaction but monitor closely
4	**Unbalanced**	**Significant level of risk** This would be assigned to Bidders of known financial weakness. A number of years losses, higher than normal working capital deficit, a negative tangible net worth which is worsening, court judgments, bad payments etc. This risk is associated with being a creditor of these companies is high or significant.	Take suitable assurances before extending credit
"-"	**Undetermined**	**Insufficient information to assign a risk indicator** This is assigned to Bidders where there is insufficient information available to express any opinion on the condition, financial soundness or payment history of the company. A company with no telephone number will also be assigned a " - " condition.	No public information or D&B proprietary Information available to indicate trading activity
		Other codes used	
N		Financial Strength is negative	
O		Financial Strength is undisclosed	
NB		New Business less than 2 years old	
NQ		Ceased Trading	

Note that if the Financial Strength indicator has been based on Issued Share Capital, the rating will include a double letter e.g. 5AA, DD etc.

Each D&B rating combines Financial Strength and Risk indicators – for example a 5A 4 rating show a Bidder with a Financial Strength of $50 + million (5A), in an unbalanced or poor condition with a significant level of risk (4). In this instance D&B would therefore recommend suitable assurance before extending/granting credit. Note, there is no formal table outlining all scenarios from the possible combinations of Tables 1 and 2 above.

Test 3 – Qualitative Analysis of Other Financial Information and Post Balance Sheet Events

This test applies to Bidders which have been rated as a 'preliminary' high or medium, on the basis of turnover and a third party rating. It provides the ability for careful discrimination between Bidders at the higher end of the spectrum of financial strength and to assist in the additional evaluation of Bidders for which no historic audited financial information is available. It requires an identification of information in the public domain that may materially affect financial strength, specifically key events which have recently taken place to the extent that they have not already been reflected in the accounts. Information to be searched includes interim statements, as well as an online search, using a business information tool such as Factiva (www.factiva.com), CreditRiskMonitor (www.creditriskmonitor.com), company press releases and analyst reports. Other key elements should include the following:

- Post balance sheet events
- Commitments and contingencies such as guarantees provided and commitments to purchase
- Obligations e.g. pension provisions, deferred tax liabilities
- Prior year adjustments
- Recent acquisitions or disposals
- Off balance sheet financing such as operating leases, lines of credit
- Other matters not captured in the financial data, such as legal actions pending

For Bidders with a 'high' rating, if the financial statements analysis does not raise any concerns, the rating is finalized as 'high'. If any material concerns are raised, the entity is rated as 'high/medium'.

For Bidders with preliminary 'medium' rating, Test 4, financial ratio analysis, should also be applied.

For Bidders without any historic financial information, the maximum final rating applied as a result of this test is 'medium', reflecting the fact that little or no information is available to indicate historic financial performance.

Additional testing available to enhance credit evaluation is the CreditRiskMonitor Z"-Score. The Z"-Score is applicable to firms in the manufacturing, merchandising and service sectors and calculates and combines 4 financial ratios, assigning each a different weighting.

Although the numbers that go into calculating the Z"-Score (and a company's financial soundness) are sometimes influenced by external factors, it provides a tool for analyzing the fluctuations of a company's financial stability over time. The score, which is based on financial statement data, is interpreted as follows:

Likelihood of Failure	
Financially sound	2.6 or higher
Neutral	1.1 to 2.6
Fiscal danger	Less than 1.1

One of the 4 variables used is the ratio of working capital to total assets. As many of the companies in the energy sector are highly leveraged, they generally have low working capital. Thus, their Z"-Scores are adversely impacted and an abnormally high percentage of companies in this sector are in the neutral and fiscal danger ranges.

Payment Index calculates the payment terms of a company on the basis of the average number of days it takes to make an invoice payment. Ranked on a scale from 1 to 10, a higher Payment Index indicates higher credit stability. The Payment Index Legend follows:

Payment Index	Meaning
10	No Past Due balances for six consecutive periods
9	0 - 10 Days Beyond Terms
8	11 - 20 Days Beyond Terms
7	21 - 30 Days Beyond Terms
6	31 - 45 Days Beyond Terms
5	46 - 60 Days Beyond Terms
4	61 - 75 Days Beyond Terms
3	76 - 90 Days Beyond Terms
2	91 - 105 Days Beyond Terms
1	106+ Days Beyond Terms

Source: www.creditriskmonitor.com

FRISK® Score – This score indicates the probability of bankruptcy for a company over a 12 month horizon, based on daily information in the CreditRiskMonitor database, as calculated by a proprietary statistical model back-tested on 7,000 companies. (see FRISK® score). The FRISK® score is reported on a 1 to 10 scale:

	FRISK®	Probability of bankruptcy within 12 months From	To
Best	10	0.00%	0.11%
	9	0.11%	0.23%
	8	0.23%	0.38%
	7	0.38%	0.54%
	6	0.54%	1.05%
	5	1.05%	1.74%
	4	1.74%	3.15%
	3	3.15%	5.05%
	2	5.05%	10.34%
Worst	1	10.34%	50.00%

Test 4: Analysis of Financial Ratios to Provide Further Detail

This test is to be applied in the event that inadequate, based on results from testing above, or insufficient data is available to clearly assess a Bidder's financial situation.

For Bidders who have a 'preliminary' rating of medium from the testing applied above, additional analysis of financial ratios is to be used as a supplement to the qualitative analysis of financial statements and post-balance sheet events.

Key financial ratios to be reviewed include those outlined in Attachment 2.

As for the previous tests, the relevant threshold levels which determine whether the entity is categorized as 'high/medium', 'medium' or 'low' should be specified for each bid package on the basis of the value of risks which are transferred to the Bidder.

7.4 Final Evaluation – Decision

Upon completion of testing of financial strength for a Bidder a decision is necessary to proceed with the final selection. The use of an evaluation matrix is recommended. Each Bidder is ranked according to their respective rating agency ranking; see Table 2, and a weighted average score as determined through Attachment 2, if required. The Bidder is assigned a final score to produce the Bidder assessment. If the score is ranked Medium or Medium/High, then additional financial support needs to be sought. If the score is Low, the Bidder is no longer considered. The use of the matrix will determine the final creditworthiness evaluation

Evaluation Matrix

Score	Rating Agency [1]	Weighted Score	Assessment
Low	<B – BB-	0 – 25%	**Not Creditworthy**
Medium	BB+ - BB	25 – 50%	**Not Creditworthy**, unless Bidder obtains third-party guarantees for the work; such party have sufficient high strength assessment
Medium/High	BB – A-	50 – 75%	**Partially creditworthy** – sufficient conventional credit support exists for project risk.
High	BBB - AAA	> 75%	**Creditworthy** – conventional contractual support required

Note 1: Based on S&P Rating; equivalent rating from other agencies may be used.

The assessment will also determine if additional financial support/guarantees is/are required. The Bidder Credit Worthiness Evaluation Form (Attachment 1) will provide an evaluation of the Bidder, including a summary of the results of the testing and Bidder acceptance, rejection or accepted with qualification(s) and provide the authorization to contract.

8.0 Activity Flowchart (Excel Format)

A.1. Not Used

9.0 Attachments/Appendices

Attachment 1 – Bidder Credit Worthiness Verification Form
Attachment 2 – Financial Evaluation Indicators, Ratios and Definitions

Attachment 1 - Bidder Credit Worthiness Verification Form

Lower Churchill Project
Bidder Credit Worthiness Verification Form

1. Bidder and Bid Information

Bid package		Value (CAD)	
Bidder name (legal entity)			
Parent company			

2. Details of Credit Worthiness Verification

Verification prepared by		Effective date	
Entity/Entities verified			

Documents used in verification

Entity	Document	Date	Comments

Notes:

3. Results of Credit Worthiness Verification

Credit Rating	
Weighted credit score	
Overall rating	

Recommendation Accept ________ Reject ________ Accept with Qualifications ________

Qualifications:

4. Authorizations and Approvals

Nalcor Corporate

The following individuals certify that this credit worthiness verification was carried out in accordance with the "Guidelines for CreditWorthiness Verification" and endorse the above noted recommendation based on that process

Corporate Treasurer and Chief Risk Officer		Date	
Assistant Treasurer		Date	

Lower Churchill Project

The following individuals have reviewed the results and are in agreement with the recommendations above

General Manager Finance		Date	
Supply Chain Management Representative		Date	
Project Director		Date	

Attachment 2 - Financial Evaluation Indicators, Ratios and Definitions

Financial Ratios for Evaluation Matrix

Ratio		Formula	Ratio Weight [A]	Target	Component Score Calculation [B]
1	FFO/Debt [1]	Net Income + D&A + Deferred Income Taxes + Other Non-Cash Items / LT Debt + Current Maturities + Commercial Paper + Other ST Borrowings	20%	45% Min [2]	Actual/Target; Max = 100%
2	Debt/Capital	LT Debt + Current Maturities + Commercial Paper + Other ST Borrowings / LT Debt + Shareholder's Equity + Minority Interests	20%	35% Max [2]	Target/Actual; Max = 100%
3	Debt/EBITDA	LT Debt + Current Maturities + Commercial Paper + Other ST Borrowings / Earnings before Interest, Taxes, Depreciation & Amortization	20%	2.0x Max [2]	Target/Actual; Max = 100%
4	EBIT Interest Coverage	Earnings before Interest and Taxes / Interest Expense	20%	1.5x Min [3]	Actual/Target; Max = 100%
5	Quick Ratio	Cash + Accounts Receivable + Cash Equivalents / Accounts Payable + Notes Payable + Accruals	20%	1.0x Min [3]	Actual/Target; Max = 100%
			100%		

Notes:

(1) FFO = Funds from Operations

(2) Target coincides with Standard & Poor's "Intermediate" financial risk profile criteria (ratings between BBB- and AA).

(3) Target based on generally accepted "rules of thumb" for these ratios.

Calculation and Assessment of Weighted Average Score

Weighted Average Score = ([A]x[B] for Ratio 1) + ([A]x[B] for Ratio 2) +...+ ([A]x[B] for Ratio 5)

Weighted Score	Assessment
0-25%	Not Creditworthy
25-50%	Not Creditworthy without guarantee/letter of credit from parent company/third party with high financial strength
50-75%	Partially Creditworthy - sufficient credit support exists for project risk
> 75%	Creditworthy - conventional contractual support required