



**CHURCHILL FALLS (LABRADOR)
CORPORATION LIMITED**

and

Twin Falls Power Corporation Limited

**Auditors' Report
and
Financial Statements**

**for the year ended
December 31, 1986**



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

OFFICERS

Chairman and Chief Executive Officer
CYRIL J. ABERY

President
JOHN P. HENDERSON

Vice-President, Finance and
Chief Financial Officer
R. ANDREW GRANT

Vice-President, Operations
and Engineering
DAVID W. REEVES

Vice-President, General Counsel
and Corporate Secretary
MAUREEN P. GREENE

Controller
JOHN C. ROBERTS

Treasurer
ROBERT D. C. TAYLOR

Assistant Corporate Secretary
FRANK A. WRIGHT

Assistant Treasurer
GERALD C. BOWERS

DIRECTORS

CYRIL J. ABERY
St. John's, Newfoundland
Chairman and Chief Executive Officer
Newfoundland and Labrador Hydro
Chairman and Chief Executive Officer
Churchill Falls (Labrador) Corporation Limited
Chairman
Lower Churchill Development Corporation Limited

JEAN BERNIER
Montreal, Quebec
General Secretary
Hydro-Quebec

*JAMES J. GREENE, Q.C.
St. John's, Newfoundland
Partner
O'Dea, Greene

JOHN P. HENDERSON
St. John's, Newfoundland
Executive Vice-President
Newfoundland and Labrador Hydro
President
Churchill Falls (Labrador) Corporation Limited

*DAVID W. MERCER
St. John's, Newfoundland
President
Newfoundland and Labrador Hydro
President and Chief Executive Officer
Lower Churchill Development Corporation Limited

*MICHAEL J. MONAGHAN, Q.C.
Corner Brook, Newfoundland
Partner
Monaghan, Seaborn, Marshall and Roberts

*DAVID S. TEMPLETON
St. John's, Newfoundland

*JEAN CLAUDE ROY
Montreal, Quebec
Vice-President
Production, Transmission and Distribution
Hydro-Quebec

HEAD AND CORPORATE OFFICE
50 Elizabeth Avenue
St. John's, Newfoundland
A1A 2X9

*Member of the Audit Committee



Peat, Marwick, Mitchell & Co.
Chartered Accountants
Viking Building
Crosbie Road
St. John's, Newfoundland A1B 3K3
(709) 722-5593

Auditors' Report to the Shareholders

We have examined the balance sheet of Churchill Falls (Labrador) Corporation Limited as at December 31, 1986 and the statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

Chartered Accountants

St. John's, Newfoundland
Canada

February 6, 1987



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

Management Report to the Shareholders

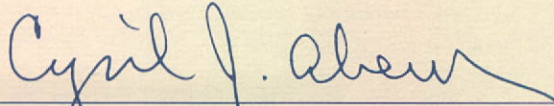
The financial statements of the Company have been prepared by Management in accordance with Canadian generally accepted accounting principles consistently applied and including information available up to February 6, 1987. The integrity and objectivity of the data in these financial statements, including estimates and judgments relating to matters not concluded by year end, are the responsibility of Management.

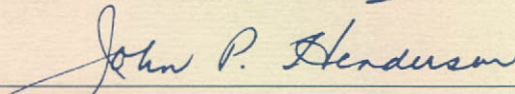
The Management of the Company maintains systems of internal accounting controls and procedures to provide reasonable assurance at reasonable cost that its assets are safeguarded against loss from unauthorized use or disposition and that the financial records provide a reliable basis for the preparation of financial statements and other data, as well as maintaining accountability for corporate assets.


The independent auditors of the Company provide an objective, independent review of Management's discharge of its responsibilities as they relate to the fairness of reported operating results and the financial conditions of the Company in accordance with generally accepted accounting principles.

The Board of Directors pursues its responsibility for these financial statements principally through its Audit Committee which meets periodically with Management as well as with the internal and independent auditors who have full and free access to the Audit Committee, and meet with it, with and without Management being present, to discuss auditing and financial report matters.

Management is responsible for and the Board of Directors has approved all of the information in the financial statements.


Chairman and Chief Executive Officer


President


Vice-President Finance
and Chief Financial Officer

St. John's, Newfoundland
Canada

February 6, 1987



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

Balance Sheet December 31, 1986 with comparative figures for 1985

	1986 (000)	1985 (000)
Assets		
Fixed assets (Note 2)		
Property, plant and equipment	\$ 717,249	729,000
Current assets		
Cash and short-term deposits	40,397	40,038
Receivables and accrued interest	19,111	19,758
Due from affiliates	6,677	4,709
Supplies and prepaid expenses	6,414	5,888
	<u>72,599</u>	<u>70,393</u>
Long-term receivable (Note 3)	20,997	25,260
Investment in Twin Falls Power Corporation Limited (Note 4)	3,761	3,456
Deferred foreign exchange loss	11,348	11,709
Unamortized debt discount and financing expenses	4,111	4,384
	<u>\$ 830,065</u>	<u>844,202</u>

Liabilities and Shareholders' Equity

	1986 (000)	1985 (000)
Long-term debt (Note 5)	\$ 504,742	520,444
Current liabilities		
Accounts payable and accrued liabilities	4,526	4,516
Royalty and rental due to the Province of Newfoundland (Note 11(a))	5,072	5,377
Long-term debt due within one year (Note 5)	<u>15,800</u>	<u>15,630</u>
	25,398	25,523
Shareholders' equity		
Share capital (Note 6)	82,900	82,900
Retained earnings (Note 7)	<u>217,025</u>	<u>215,335</u>
	299,925	298,235
	 <u><u>\$ 830,065</u></u>	 <u><u>844,202</u></u>

See accompanying notes

On behalf of the Board:

Signed: Cyril J. Abew
Director

Signed: D. S. Templeton
Director



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

Statement of Income and Retained Earnings

Year ended December 31, 1986
with comparative figures for 1985

	1986 (000)	1985 (000)
Revenue		
Sales of power (Note 8)	\$ 92,185	94,365
Rental of rights and facilities to Twin Falls Power Corporation Limited	735	735
Equity in net income of Twin Falls Power Corporation Limited for the year (Note 4)	605	553
Total revenue	<u>93,525</u>	<u>95,653</u>
Expenses		
Operating costs	18,994	17,543
Horsepower royalty and Newfoundland rental (Note 11(a))	5,110	5,377
Interest (Note 9)	23,062	22,256
Depreciation	13,287	13,264
Total expenses	<u>60,453</u>	<u>58,440</u>
Net income for the year	33,072	37,213
Retained earnings at beginning of year	215,335	210,810
	<u>248,407</u>	<u>248,023</u>
Dividends (Note 7)	31,382	32,688
Retained earnings at end of year	<u>\$ 217,025</u>	<u>215,335</u>

See accompanying notes



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

Statement of Changes in Financial Position Year Ended December 31, 1986 with comparative figures for 1985

	1986 (000)	1985 (000)
Operating Activities		
Net income	\$ 33,072	37,213
Adjusted for items not involving a cash flow		
Depreciation	13,287	13,264
Amortization of debt discount and financing expenses	273	274
Amortization of deferred foreign exchange loss	361	507
Increase in equity in net income of Twin Falls Power Corporation Limited	(605)	(553)
	<u>46,388</u>	<u>50,705</u>
 Net changes in operating elements of working capital (excluding cash and current portion of long-term debt)	 (141)	 (4,147)
Decrease in long-term receivable	4,263	4,138
 Cash provided by operating activities	 <u>50,510</u>	 <u>50,696</u>
 Dividends	 <u>(31,382)</u>	 <u>(32,688)</u>
Investment Activities		
Additions to property, plant and equipment	(1,537)	(1,555)
Dividends from Twin Falls Power Corporation Limited	300	—
 Cash used in investment activities	 <u>(1,237)</u>	 <u>(1,555)</u>
Financing Activities		
Debt retired	(15,532)	(21,190)
 Cash used in financing activities	 <u>(15,532)</u>	 <u>(21,190)</u>
 Net increase (decrease) in cash	 2,359	 (4,737)
Cash position at beginning of year	44,538	49,275
Cash position at end of year	<u>\$ 46,897</u>	<u>44,538</u>
 Cash is represented by:		
Cash and short-term deposits	\$ 40,397	40,038
Promissory notes due from affiliate	6,500	4,500
	<u>\$ 46,897</u>	<u>44,538</u>

See accompanying notes



CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED

Notes to Financial Statements December 31, 1986

Churchill Falls (Labrador) Corporation Limited ("Churchill Falls") is incorporated under the laws of Canada and operates a hydro-electric generating plant and related transmission facilities in Labrador with a rated capacity of 5,400 megawatts ("Project"). The Project operates under rights leased from the Province of Newfoundland ("Province") for 99 years under the Churchill Falls (Labrador) Corporation Limited (Lease) Act, 1961, ("Lease") as amended covering the water power potential of the Upper Churchill watershed. A power contract with Hydro-Quebec dated May 12, 1969 ("Power Contract") provides for the sale of substantially all the energy from the Project for an initial period expiring in 2016 with an automatic renewal for a further period of 25 years. In 1976 the Province requested Churchill Falls to supply 800 megawatts of power, commencing in 1983, pursuant to the Lease to meet the Province's requirements. This request was denied and legal action was commenced and is continuing against Churchill Falls (see Note 11(b)(i)).

1. *Summary of Significant Accounting Policies*

The accounting policies followed by Churchill Falls are in accordance with generally accepted accounting principles in Canada.

Investment in Twin Falls Power Corporation Limited

Although Churchill Falls owns voting control (66 2/3%) of Twin Falls Power Corporation Limited ("Twin Falls"), the equity interest in Twin Falls is 33 1/3%, and as the principal assets and the credit resources of Twin Falls cannot be transferred to Churchill Falls, consolidation is not considered appropriate and the investment is carried on an equity basis (see Note 4).

Depreciation and Amortization

- (a) Churchill Falls provides depreciation at a rate of 1 1/2% per annum on a straight-line basis on property, plant and equipment.
- (b) Debt discount and financing expenses are being amortized on a straight-line basis over the estimated term of the First Mortgage Bonds.

Foreign Currencies

Foreign currency transactions are translated into their Canadian dollar equivalent as follows:

- (a) At the transaction date, each asset, liability, revenue or expense is translated using exchange rates in effect at that date.
- (b) At each balance sheet date monetary assets and liabilities are translated using exchange rates at that date.
- (c) Foreign exchange gains and losses are included in income in the current period except for unrealized gains and losses related to First Mortgage Bonds. Under the Power Contract Churchill Falls recovers a portion of the difference between actual exchange rates prevailing at the settlement dates of its First Mortgage Bonds and a Weighted Averaged Exchange Rate as defined in the Power Contract. The foreign exchange loss not recoverable under the Power Contract is being amortized to operations over the remaining life of the debt.

Insurance

Churchill Falls has adopted the policy of appropriating a portion of retained earnings as a reserve for self insurance of risks for direct damage to assets and related loss of revenue with respect to deductibles stipulated in its insurance policies.

2. Fixed Assets

	1986 (000)	1985 (000)
Property, plant and equipment, at cost	\$ 886,089	884,595
Less accumulated depreciation	<u>168,840</u>	<u>155,595</u>
	<u>\$ 717,249</u>	<u>729,000</u>

These assets of Churchill Falls are pledged as security for long-term debt.

3. Long-Term Receivable

The long-term receivable relates to the additional revenue referred to in Note 8 (b) plus interest referred to in Note 9. Payments of the amount related to the initial review period will be received in monthly instalments over an eight year period which commenced September 1, 1984. Payments of the amount related to the four year review will commence in 1988. The receivable bears interest at 7% per annum from September 1, 1984, which interest is payable concurrently with each instalment. Details of the receivable are as follows:

	1986 (000)	1985 (000)
Additional revenue pursuant to the initial review plus interest to August 31, 1984	\$ 35,276	35,276
Payments received	<u>10,289</u>	<u>5,879</u>
	24,987	29,397
Reclassified to current receivables	<u>4,410</u>	<u>4,410</u>
	20,577	24,987
Interest adjustment pursuant to the four year review	<u>420</u>	<u>273</u>
Long-term receivable	<u>\$ 20,997</u>	<u>25,260</u>

4. Investment in Twin Falls

	1986 (000)	1985 (000)
Shares, at cost	\$ 2,500	2,500
Equity in retained earnings at beginning of year	\$ 956	403
Equity in net income for the year	<u>605</u>	<u>553</u>
	1,561	956
Dividends for the year	<u>300</u>	<u>956</u>
	<u>\$ 3,761</u>	<u>\$ 3,456</u>

5. Long-Term Debt

Details of long-term debt at December 31 are as follows:

	1986		1985	
	(000)	(U.S. 000)	(000)	(U.S. 000)
First Mortgage Bonds				
7 3/4% Series A due December 15, 2007				
Authorized		\$ 500,000		<u>500,000</u>
Issued	\$ 528,414	<u>500,000</u>	528,414	<u>500,000</u>
Retired	<u>132,267</u>	<u>125,155</u>	<u>119,686</u>	<u>113,251</u>
Outstanding at December 31	396,147	374,845	408,728	386,749
Due within one year	<u>12,859</u>	<u>11,316</u>	<u>12,660</u>	<u>11,979</u>
Long-term debt	<u>383,288</u>	<u>363,529</u>	<u>396,068</u>	<u>374,770</u>
7 7/8 Series B due December 15, 2007				
Authorized	\$ <u>50,000</u>		<u>50,000</u>	
Issued	50,000		50,000	
Retired	<u>12,418</u>		<u>11,239</u>	
Outstanding at December 31	37,582		38,761	
Due within one year	<u>1,205</u>		<u>1,198</u>	
Long-term debt	<u>36,377</u>		<u>37,563</u>	
General Mortgage Bonds				
7 1/2% due three years after latest maturity of any First Mortgage Bonds				
Authorized	\$ <u>100,000</u>		<u>100,000</u>	
Issued	100,000		100,000	
Retired	<u>13,187</u>		<u>11,415</u>	
Outstanding at December 31	86,813		88,585	
Due within one year	<u>1,736</u>		<u>1,772</u>	
Long-term debt	<u>85,007</u>		<u>86,813</u>	
Total long-term debt	<u>\$ 504,742</u>		<u>520,444</u>	

First Mortgage Bonds

The Series A and Series B bonds are repayable in fixed semi-annual and in contingent annual sinking fund instalments which commenced June 1978

General Mortgage Bonds

The Deed of Trust and Mortgage securing the General Mortgage Bonds provides for semi-annual sinking fund payments which commenced in June 1980. Each payment will be an amount equal to 1% of the aggregate principal amount outstanding on January 1 preceding each payment date. These bonds are subordinate to the First Mortgage Bonds.

Repayment of Long-Term Debt

Due to the contingent nature of the amounts of certain of the sinking fund instalments it is not possible to be precise concerning long-term debt repayments over the next five years, but these, if made in accordance with sinking fund provisions applicable to Churchill Falls as a taxable corporation, are estimated to be \$16,000,000 in each of the years 1987 to 1991 inclusive.

6. Share Capital

The share capital of Churchill Falls as at December 31, 1986 and 1985 is summarized below:

	Shares	Amount (000)
Common shares without nominal or par value		
Authorized	10,000,000	
Issued and fully paid	8,759,999	\$ 82,900
Preferred shares without nominal or par value		
Authorized, issued and fully paid	3	—

Additional shares cannot be issued without the approval from the holders of at least 75% of the outstanding common shares.

The preferred shares are divided into three classes and the dividends thereon, which rank *pari passu* but ahead of dividends on common shares are as follows:

The Class A Cumulative Preferred Shareholder is entitled to dividend payments calculated as the amount equal to the income taxes which would have been received by the Province had Churchill Falls continued to be a taxable corporation.

The Class B Redeemable Cumulative Preferred Shareholder is entitled to dividends equal to the Additional Quebec Interest Subsidy Payment, as defined, during the life of the First Mortgage Bonds.

The Class C Redeemable Cumulative Preferred Shareholder is entitled to dividends equal to the Additional Newfoundland Interest Subsidy Payment, as defined, during the life of the First Mortgage Bonds.

7. Retained Earnings

Under the terms of the long-term debt instruments, Churchill Falls may pay cash dividends only out of earnings, as defined, accumulated from September 1, 1976. At December 31, 1986 the amount of retained earnings available for cash dividends was \$31,554,000 (1985 - \$36,966,000). The policy of the company is to relate dividends to cash flow and therefore dividend payments will be influenced by the receipt of the long-term receivable (Note 3). Subsequent to December 31, 1986 the Directors declared a dividend on the Class A preferred share amounting to \$350,000 and a dividend on the common shares amounting to \$5,781,599.

At December 31, 1986 \$5,000,000 (1985 - \$4,900,000) of the retained earnings has been appropriated as a reserve for self insurance.

8. Sales of Power

- (a) Sales of power under the Power Contract have been recorded at mill rates based on a determination by an independent auditor that the Final Capital Cost of the Project is \$887,575,000. Hydro-Quebec and Churchill Falls implemented an increase in rates during 1981 without prejudice to the rights of either party in further negotiations or in a judicial review of the Final Capital Cost pursuant to the provisions of the Power Contract. Churchill Falls instituted proceedings in November, 1984 in the Quebec Superior Court claiming that the Final Capital Cost is in excess of \$900,000,000, the maximum to be used as a basis for the mill rate. Hydro-Quebec filed a preliminary motion concerning whether Churchill Falls could institute the action, which motion was heard January 21, 1985. On February 11, 1985 the Court upheld the preliminary motion and stated that it lacked jurisdiction over the subject matter of the action as drafted by Churchill Falls. Churchill Falls has appealed this judgment.
- (b) The terms Energy Payable and Annual Energy Base are defined in the Power Contract. Section 8.5.2 of the Power Contract provides for an initial eight year review and subsequent four year reviews of the annual average Energy Payable for comparison with the annual Energy Base then in effect. When the annual average Energy Payable exceeds the Annual Energy Base in effect an additional payment is due from Hydro-Quebec, the amount being calculated in accordance with Article VIII of the Power Contract. Conversely, if a shortfall should occur, a refund would be due from Churchill Falls to Hydro-Quebec. Article IX of the Power Contract provides for adjustment to the Annual Energy Base where applicable in the same time intervals.

Energy delivered to Hydro-Quebec during the period September 1, 1976 to August 31, 1984 was reviewed in September 1984 to determine the annual average Energy payable for comparison with the Annual Energy Base in effect during the period. The annual average Energy payable during the initial period was determined to be in excess of the Annual Energy Base, thereby resulting in an adjustment in 1984, which amount was included in sales of power in December 1984. The Annual Energy Base was also reviewed pursuant to Article IX and was increased from 31.5 billion kwhs per annum (30.74 billion kwhs applicable to Hydro-Quebec) to 32.2 billion kwhs per annum (31.44 billion kwhs applicable to Hydro-Quebec), the maximum permissible under the Power Contract.

9. Interest

Churchill Falls recovers the different between interest calculated at the rates described in the Power Contract and interest paid on its long-term debt together with a portion of the difference between actual exchange rates prevailing at the time of the interest payments and the Weighted Average Exchange Rate as defined in the Power Contract.

An analysis of interest and amortization of debt discount and financing expenses is as follows:

	1986 (000)	1985 (000)
Gross interest	\$ 54,828	57,671
Less: Interest income related to revenue adjustment (See Notes 3 and 8(b))	\$ 2,058	2,490
Interest income	5,041	6,050
Recovered from power customers	<u>24,940</u>	<u>27,149</u>
	<u>32,039</u>	<u>35,689</u>
Net interest expense	22,789	21,982
Amortization of debt discount and financing expenses	273	274
	<u>\$ 23,062</u>	<u>22,256</u>

Also, Churchill Falls can require Hydro-Quebec to make additional advances, against the issue of units of Subordinate Debentures and shares of common stock, to service its debt and to cover its expenses if funds are not otherwise available.

10. Income Taxes

Churchill Falls qualifies for exemption from payment of income taxes under Section 149(1)(d) of the Income Tax Act.

11. Commitments and Contingencies

- (a) Under the terms of the Lease and amendments thereto Churchill Falls is required to pay an annual rental of 8% of the consolidated net profits before income taxes, as defined, and an annual royalty of \$.50 per horsepower year generated, as defined.
- (b) (i) A request was made by the Province in 1976 for Churchill Falls to supply 800 megawatts of power pursuant to Clause 2(e) of Part 1 of the Lease to meet the Province's requirements commencing in 1983. The request was denied and legal action was commenced against Churchill Falls. The trial of this action concluded July 8, 1982 and on June 13, 1983 the Newfoundland Supreme Court, Trial Division, denied the Province's request. This judgment was appealed to the Newfoundland Supreme Court, Court of Appeal which heard the appeal on October 15-18, 1984. On October 25, 1985 the Court of Appeal dismissed the Province's appeal. On May 22, 1986 the Supreme Court of Canada granted the Province leave to appeal this judgment. No date has been set for the hearing of the appeal.
- (ii) In June 1977, Hydro-Quebec commenced an action against Churchill Falls in the Superior Court in Montreal to obtain a declaration as to certain rights and obligations of the parties under the Power Contract should Churchill Falls comply with the Province's request referred to in Note 11(b)(i). On August 4, 1983 judgment was rendered in which the Superior Court stated that, inter alia, failure by Churchill Falls to supply Hydro-Quebec all the power and energy pursuant to the Power Contract would be a breach of the Power Contract. This judgment was appealed by Churchill Falls, and on February 18, 1985 the Quebec Court of Appeal rendered its judgment dismissing the appeal. The Supreme Court of Canada granted Churchill Falls leave to appeal this judgment on May 22, 1986. No date has been set for the hearing of the appeal.
- (c) Under the terms of a sublease with Twin Falls, expiring on December 31, 1989, with a twenty-five year renewal option under certain conditions, Churchill Falls is required to deliver to Twin Falls, at an agreed price, horsepower equivalent to the installed horsepower of the Twin Falls plant and to maintain the Twin Falls plant and equipment.

- (d) Hydro-Quebec has notified Churchill Falls that it does not agree with the method of calculating the amount of foreign exchange loss to be shared between Churchill Falls and Hydro-Quebec since 1979 as provided for in the Power Contract. Resolution of this question will be the subject of further discussion between Churchill Falls and Hydro-Quebec.

12. *Pension Plans*

Churchill Falls has two private pension plans, one for salaried and one for hourly paid employees and in addition a number of salaried and hourly paid employees are covered by the Public Service Pension Plan. Both Churchill Falls plans are fully funded and managed by a trustee. Based on the most recent actuarial valuations each Churchill Falls plan is in a surplus position.

13. *Statement of Changes in Financial Position*

The 1986 Statement of Changes in Financial Position focuses on changes in cash. The 1985 comparative figures which were originally presented on a working capital basis, have been restated to conform to the 1986 presentation.

Twin Falls Power Corporation Limited

OFFICERS

President

JOHN P. HENDERSON

Vice-President, Finance

R. ANDREW GRANT

Vice-President, Operations
and Engineering

DAVID W. REEVES

General Counsel
and Corporate Secretary

MAUREEN P. GREENE

Controller

JOHN C. ROBERTS

Treasurer

ROBERT D. C. TAYLOR

Assistant Corporate Secretary

FRANK A. WRIGHT

Assistant Treasurer

GERALD C. BOWERS

DIRECTORS

FRANK H. CARTER

Montreal, Quebec

General Solicitor

Pickands, Mather & Company

T. DAVID COLLETT

St. John's, Newfoundland

Vice-President, Operations

Newfoundland and Labrador Hydro

J. HARRY FATUM

Cleveland, Ohio, U.S.A.

General Manager, Research & Planning

Pickands, Mather & Company

R. ANDREW GRANT

St. John's, Newfoundland

Vice-President, Finance and

Chief Financial Officer

Newfoundland and Labrador Hydro

Churchill Falls (Labrador) Corporation Limited

MAUREEN P. GREENE

St. John's, Newfoundland

Vice-President, General Counsel

& Corporate Secretary

Newfoundland and Labrador Hydro

Churchill Falls (Labrador) Corporation Limited

JOHN P. HENDERSON

St. John's, Newfoundland

Executive Vice-President

Newfoundland and Labrador Hydro

President

Churchill Falls (Labrador) Corporation Limited

ROBERT A. MARTIN

Sept Iles, Quebec

Senior Vice-President

Iron Ore Company of Canada

*WALTER F. MILLER

Cleveland, Ohio, U.S.A.

Executive Vice-President

Iron Ore Company of Canada

DAVID W. REEVES

Churchill Falls, Labrador

Vice-President, Operations and Engineering

Churchill Falls (Labrador) Corporation Limited

HEAD OFFICE

50 Elizabeth Avenue

St. John's, Newfoundland

A1A 2X9

*Resigned December 31, 1986



Peat, Marwick, Mitchell & Co.
Chartered Accountants
Viking Building
Crosbie Road
St. John's, Newfoundland A1B 3K3
(709) 722-5593

Auditors' Report to the Shareholders

We have examined the balance sheet of Twin Falls Power Corporation Limited as at December 31, 1986 and the statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

Chartered Accountants

St. John's, Newfoundland
Canada

February 6, 1987

Twin Falls Power Corporation Limited

Balance Sheet December 31, 1986 with comparative figures for 1985

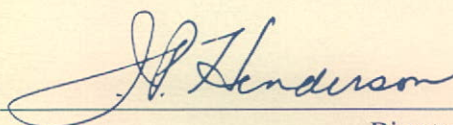
	1986 (000)	1985 (000)
Assets		
Fixed assets (Notes 2 and 3)		
Plant and equipment	\$ 23,406	25,383
Current Assets		
Cash and short-term deposits	657	1,281
Receivables — trade	707	436
	<u>1,364</u>	<u>1,717</u>
	<u>\$ 24,770</u>	<u>27,100</u>

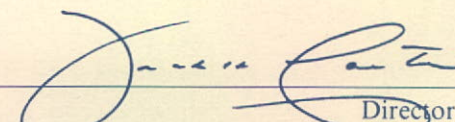
Liabilities and Shareholders' Equity

	1986 (000)	1985 (000)
Long-term debt (Note 3)	\$ 992	1,603
Current liabilities		
Due to affiliate	108	119
Income taxes	209	321
Long-term debt due within one year (Note 3)	611	2,204
	928	2,644
Deferred income taxes	11,565	12,485
Shareholders' equity		
Share capital (Note 4)	7,500	7,500
Retained earnings (Note 3)	3,785	2,868
	11,285	10,368
	\$ 24,770	27,100

See accompanying notes

On behalf of the Board:

Signed: 
Director

Signed: 
Director

Twin Falls Power Corporation Limited

Statement of Income and Retained Earnings

For the year ended December 31, 1986

with comparative figures for 1985

	1986 (000)	1985 (000)
Revenue		
Sales of power	\$ 8,826	9,153
Expenses		
Cost of power (Note 5)	2,015	2,291
Interest on long-term debt	172	381
Depreciation	<u>1,990</u>	<u>1,987</u>
Total expenses	<u>4,177</u>	<u>4,659</u>
Income before the following	4,649	4,494
Interest income	<u>91</u>	<u>198</u>
Income before income taxes	<u>4,740</u>	<u>4,692</u>
Income taxes (Note 6) — Current	3,842	3,926
— Deferred	<u>(919)</u>	<u>(894)</u>
	<u>2,923</u>	<u>3,032</u>
Net income for the year	1,817	1,660
Retained earnings at beginning of year	<u>2,868</u>	<u>1,208</u>
	4,685	2,868
Dividends	<u>900</u>	<u>—</u>
Retained earnings at end of year	<u>\$ 3,785</u>	<u>2,868</u>

See accompanying notes

Twin Falls Power Corporation Limited

Statement of Changes in Financial Position

For the year ended December 31, 1986 (Note 7)

with comparative figures for 1985

	1986 (000)	1985 (000)
Operating Activities		
Net income	\$ 1,817	1,660
Adjusted for items not involving a cash flow		
Depreciation	1,990	1,987
Deferred income taxes	<u>(919)</u>	<u>(894)</u>
	2,888	2,753
 Net changes in operating elements of working capital (excluding cash and current portion of long-term debt.).....	 <u>(394)</u>	 <u>109</u>
 Cash provided by operating activities	 <u>2,494</u>	 <u>2,862</u>
 Dividends	 <u>(900)</u>	 <u>—</u>
Investment Activities		
Additions to plant and equipment	<u>(14)</u>	<u>(89)</u>
Cash used in investment activities	<u>(14)</u>	<u>(89)</u>
Financing Activities		
Reduction in long-term debt	<u>(2,204)</u>	<u>(3,667)</u>
Cash used in financing activities	<u>(2,204)</u>	<u>(3,667)</u>
 Net decrease in cash	 <u>(624)</u>	 <u>(894)</u>
Cash position at beginning of year	<u>1,281</u>	<u>2,175</u>
 Cash position at end of year	 <u>\$ 657</u>	 <u>1,281</u>

See accompanying notes

Twin Falls Power Corporation Limited

Notes to Financial Statements December 31, 1986

Twin Falls Power Corporation Limited ("Twin Falls") is incorporated under the laws of Canada and has developed a 225 megawatt hydro-electric generating plant on the Unknown River in Labrador. The plant has been inoperative since 1974 (refer to Note 5).

1. Summary of Significant Accounting Policies

The accounting policies followed by Twin Falls are in accordance with generally accepted accounting principles in Canada.

Depreciation

- (a) Plant and related equipment is depreciated using the straight-line method at a rate of 3% per annum.
- (b) Other furniture and equipment is depreciated using the straight-line method at a rate of 10% per annum.

Foreign Currencies

Since the funds required to service The First Mortgage Bonds are made available in U.S. dollars under long-term power contracts without loss or gain on exchange to Twin Falls, this debt is carried in the accounts at the proceeds realized in Canadian dollars. All other accounts in foreign currencies are stated in Canadian dollars at the exchange rate in effect at the balance sheet date.

2. Fixed Assets

	1986 (000)	1985 (000)
Plant and equipment, at cost	\$ 66,388	66,375
Less accumulated depreciation	<u>42,982</u>	<u>40,992</u>
	<u>\$ 23,406</u>	<u>25,383</u>

3. Long-Term Debt

The following amounts of 5 1/2% First Mortgage Bonds Series A due June 30, 1986, and 6 1/4% First Mortgage Bonds Series B due June 30, 1989, have been authorized, issued and retired by Twin Falls pursuant to the terms of the Deed of Trust and Mortgage ("Trust Deed") as amended:

	1986		1985	
	(000)	(U.S. 000)	(000)	(U.S. 000)
Series A				
Authorized	\$ <u>45,256</u>	<u>42,500</u>	45,256	42,500
Issued	<u>42,061</u>	<u>39,500</u>	42,061	39,500
Retired	<u>42,061</u>	<u>39,500</u>	40,433	37,971
Outstanding at December 31	—	—	1,628	1,529
Due within one year	<u>—</u>	<u>—</u>	<u>1,628</u>	<u>1,529</u>
Long-term debt	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Series B				
Authorized	\$ <u>10,783</u>	<u>10,000</u>	<u>10,783</u>	<u>10,000</u>
Issued	<u>8,626</u>	<u>8,000</u>	8,626	8,000
Retired	<u>7,023</u>	<u>6,513</u>	6,447	5,979
Outstanding at December 31	<u>1,603</u>	<u>1,487</u>	2,179	2,021
Due within one year	<u>611</u>	<u>567</u>	576	534
Long-term debt	<u>992</u>	<u>920</u>	<u>1,603</u>	<u>1,487</u>
Total long-term debt	\$ <u>992</u>	<u>920</u>	<u>1,603</u>	<u>1,487</u>

Estimated repayments of First Mortgage Bonds over the next three years are:

	(000)	(U.S. 000)
1987	\$ 611	567
1988	650	603
1989	342	317

The Series A Bonds were retired in June 1986. The Series B Bonds are repayable in equal semi-annual instalments of principal and interest and are secured by a first fixed and specific mortgage, pledge and charge on plant and equipment and long-term power and other contracts and a first floating charge on all other assets of Twin Falls. Certain restrictions are placed by the Trust Deed on the payment of dividends other than stock dividends.

4. Share Capital

Authorized

500,000 Class A shares without nominal or par value.

1,000,000 Class B shares without nominal or par value.

Issued and fully paid

250,000 Class A shares	\$ 250,000
500,000 Class B shares	<u>5,000,000</u>
	<u>\$ 7,500,000</u>

The issued Class A shares are owned by Churchill Falls (Labrador) Corporation Limited ("Churchill Falls") and the issued Class B shares are owned by the present long-term customers of Twin Falls. The Class A shares are entitled to four votes per share and the Class B shares are entitled to one vote per share but rank *pari passu* in all other respects.

5. Commitments

Twin Falls has a sublease from Churchill Falls giving Twin Falls the right to develop the hydro-electric power potential of the Unknown River, a tributary of the Churchill River, at the site of the Twin Falls plant. The sublease expires December 31, 1989, but may be renewed for a term of 25 years under certain conditions, if Twin Falls so requests. Certain rights under the sublease were suspended by Churchill Falls with effect from June 30, 1974 with the result that Churchill Falls is diverting the flow of water from the Twin Falls plant and using the facilities of Twin Falls as required. In consideration for this suspension of rights, Churchill Falls is required to deliver to Twin Falls, during the unexpired term of the sublease or any renewal thereof, horsepower equivalent to the installed horsepower of the Twin Falls plant. Twin Falls is obliged to purchase this power for an amount equal to the average annual cost of operating the Twin Falls plant for the five-year period ended March 31, 1974. In addition, Twin Falls is required to pay annually to Churchill Falls a rental amounting to \$305,000 and \$1.40 per installed horsepower. Twin Falls also pays to Churchill Falls an annual royalty of \$.50 per horsepower year generated, as defined, all calculated as though the power delivered by Churchill Falls to Twin Falls has been generated in the Twin Falls plant.

6. Income Taxes

The income tax provision included in the statement of income is based on a rate which is different from the prevailing rate primarily because of the treatment of losses on the redemption of bonds for income tax purposes.

7. Statement of Changes in Financial Position

The 1986 Statement of Changes in Financial Position focuses on changes in cash. The 1985 comparative figures which were originally presented on a working capital basis, have been restated to conform to the 1986 presentation.

