NEWFOUNDLAND AND LABRADOR HYDRO –
A NALCOR ENERGY COMPANY

Consolidated Financial Statements

December 31, 2008

NEWFOUNDLAND AND LABRADOR HYDRO
CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008

Deloitte & Touche LLP
10 Factory Lane
Fort William Building
St. John's NL A1C 6H5
Canada

Tel: (709) 576-8480
Fax: (709) 576-8460
www.deloitte.ca

Auditors' Report

To the Lieutenant-Governor in Council
Province of Newfoundland and Labrador

We have audited the consolidated balance sheet of Newfoundland and Labrador Hydro (the "Company") as at December 31, 2008 and the consolidated statements of income and retained earnings and comprehensive income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles. As required by The Hydro Corporation Act, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year, except as disclosed in Note 2.

Deloitte & Touche LLP

Chartered Accountants
February 20, 2009

BOARD OF DIRECTORS

JOHN OTTENHEIMER (Chair)
Lawyer and Corporate Director

EDMUND J. MARTIN
President and Chief Executive Officer
Nalcor Energy

TOM CLIFT
Associate Dean Academic Programs
Faculty of Business
Memorial University of Newfoundland

KEN MARSHALL
President
Rogers Cable - Atlantic Region

CATHY BENNETT
Owner/Operator
Bennett Restaurants Ltd.

OFFICERS

JOHN OTTENHEIMER
Chairman

EDMUND J. MARTIN
President and Chief Executive Officer

DERRICK F. STURGE
Vice-President, Finance and Chief Financial Officer

JAMES R. HAYNES
Vice-President, Regulated Operations

JOHN E. MALLAM
Vice-President, Engineering Services

JIM M. KEATING
Vice-President, Nalcor Energy – Oil and Gas

ANDREW E. MacNEILL
Vice-President, Nalcor Energy – Churchill Falls

GERARD V. McDONALD
Vice-President, Human Resources and
Organizational Effectiveness

GILBERT J. BENNETT
Vice-President, Lower Churchill Project

WAYNE D. CHAMBERLAIN
General Counsel and Corporate Secretary

PETER A. HICKMAN
Assistant Corporate Secretary

MARK G.S. BRADBURY
Corporate Treasurer

GLENN H. MITCHELL
Corporate Controller

HEAD AND CORPORATE OFFICE
P.O. Box 12400
St. John's, Newfoundland and Labrador
A1B 4K7

NEWFOUNDLAND AND LABRADOR HYDRO
CONSOLIDATED BALANCE SHEET

As at December 31 (millions of dollars)	**2008**	2007
ASSETS		
Current assets		
Cash and cash equivalents	**4.1**	7.2
Short-term investments	**14.6**	11.5
Accounts receivable	**76.6**	80.2
Current portion of long-term receivable	**-**	0.5
Current portion of regulatory assets (Note 4)	**5.0**	17.2
Fuel and supplies	**52.7**	69.7
Prepaid expenses	**1.6**	1.2
	154.6	187.5
Property, plant and equipment (Notes 3 and 19(e))	**1,702.4**	1,825.7
Long-term receivables (Note 5)	**26.7**	23.3
Sinking funds (Notes 8 and 14)	**163.9**	151.8
Regulatory assets (Note 4)	**74.6**	81.3
Investments (Note 6)	**-**	5.2
Reserve fund (Note 18(b))	**23.4**	11.5
	2,145.6	2,286.3
LIABILITIES AND SHAREHOLDER'S EQUITY		
Current liabilities		
Bank indebtedness (Note 8)	**5.7**	9.1
Accounts payable and accrued liabilities	**55.1**	75.9
Accrued interest	**28.7**	30.7
Current portion of long-term debt (Note 8)	**9.1**	209.1
Current portion of regulatory liabilities (Note 4)	**22.3**	23.5
Deferred capital contribution (Note 19(f))	**2.2**	-
Promissory notes (Note 8)	**163.0**	7.0
Due to related parties (Notes 14 and 19)	**2.9**	-
	289.0	355.3
Long-term debt (Notes 8 and 14)	**1,175.7**	1,187.8
Regulatory liabilities (Note 4)	**31.5**	15.5
Employee future benefits (Notes 10 and 19(e))	**49.9**	47.4
Long-term payable (Note 9)	**0.7**	-
	82.1	62.9
Non-controlling interest in Lower Churchill Development Corporation (Note 6)	**-**	2.5
Shareholder's equity		
Share capital (Note 11)	**22.5**	22.5
Contributed capital (Notes 11 and 19(e))	**111.8**	114.0
Accumulated other comprehensive income (Notes 13 and 14)	**16.5**	19.5
Retained earnings (Note 19(e))	**448.0**	521.8
	598.8	677.8
Commitments and contingencies (Note 18)		
	2,145.6	2,286.3

See accompanying notes

On behalf of the Board:

John Ottenheimer

JOHN OTTENHEIMER
DIRECTOR

ED MARTIN
DIRECTOR

NEWFOUNDLAND AND LABRADOR HYDRO
CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

Year ended December 31 (millions of dollars)	**2008**	2007
Revenue		
Energy sales (Notes 1 and 21)	**563.3**	567.5
Other	**5.6**	5.9
	568.9	573.4
Expenses		
Operations and administration	**141.8**	143.1
Fuels	**164.8**	159.2
Power purchased	**41.0**	38.4
Amortization	**53.0**	50.7
Interest (Note 15)	**78.8**	100.4
Write-down of investment (Note 6)	**2.7**	-
	482.1	491.8
Net income	**86.8**	81.6
Retained earnings, beginning of year	**521.8**	437.9
Add: adjustment to long-term debt (Note 14)	**-**	2.3
Deduct: adjustment to retained earnings (Note 19(e))	**160.6**	-
Retained earnings, end of year	**448.0**	521.8

See accompanying notes

NEWFOUNDLAND AND LABRADOR HYDRO
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Year ended December 31 (millions of dollars)	**2008**	2007
Net income	**86.8**	81.6
Other comprehensive income		
Change in fair value of sinking fund and reserve fund investments	**(3.0)**	0.2
Comprehensive income	**83.8**	81.8

See accompanying notes

NEWFOUNDLAND AND LABRADOR HYDRO
CONSOLIDATED STATEMENT OF CASH FLOWS

Year ended December 31 (millions of dollars)	**2008**	2007
Cash provided by (used in)		
Operating activities		
Net income	**86.8**	81.6
Adjusted for items not involving a cash flow		
Amortization	**53.0**	50.7
Accretion of long-term debt	**0.5**	0.8
Loss on disposal of property, plant and equipment	**2.5**	1.0
Foreign exchange gain	**-**	(0.3)
Write-down of investments	**2.7**	-
Other	**-**	(0.1)
	145.5	133.7
Changes in non-cash working capital balances (Note 16)	**31.7**	42.5
	177.2	176.2
Financing activities		
Increase (decrease) in promissory notes	**156.0**	(51.8)
Long-term debt retired	**(207.5)**	(13.1)
Advance to Nalcor (Note 19(e))	**(3.0)**	-
Foreign exchange loss recovered	**-**	0.1
Increase in deferred capital contribution	**2.2**	-
	(52.3)	(64.8)
Investing activities		
Additions to property, plant and equipment	**(90.1)**	(86.5)
Increase in sinking funds	**(20.8)**	(19.6)
(Increase) decrease in short-term investments	**(3.1)**	0.2
Increase in reserve fund	**(11.3)**	(11.5)
Proceeds on disposal of property, plant and equipment	**0.7**	0.6
	(124.6)	(116.8)
Net increase (decrease) in cash	**0.3**	(5.4)
Cash position, beginning of year	**(1.9)**	3.5
Cash position, end of year	**(1.6)**	(1.9)
Cash position is represented by		
Cash and cash equivalents	**4.1**	7.2
Bank indebtedness	**(5.7)**	(9.1)
	(1.6)	(1.9)
Supplementary disclosure of cash flow information		
Income taxes paid	**0.1**	0.2
Interest income received	**0.9**	1.2
Interest paid	**101.6**	105.4

See accompanying notes

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

Newfoundland and Labrador Hydro ("Hydro") is incorporated under a special act of the Legislature of the Province of Newfoundland and Labrador ("Province") as a Crown corporation and its principal activity is the development, generation and sale of electricity.

Gull Island Power Corporation ("GIPCo.") is incorporated under the laws of Canada. Its objective was to develop the hydroelectric potential at Gull Island on the Lower Churchill River in Labrador, and construct a direct current transmission system from Labrador to the island of Newfoundland. Lower Churchill Development Corporation ("LCDC") is incorporated under the laws of Newfoundland and Labrador and was established with the objective of developing all or part of the hydroelectric potential of the Lower Churchill River ("Lower Churchill Development"). Both GIPCo. and LCDC are inactive.

Churchill Falls (Labrador) Corporation Limited ("Churchill Falls") is incorporated under the laws of Canada and has completed and commissioned a hydroelectric generating plant and related transmission facilities situated in Labrador which has a rated capacity of 5,428 megawatts ("Churchill Falls Project"). Twin Falls Power Corporation ("Twin Falls") is incorporated under the laws of Canada and has developed a 225 megawatt hydroelectric generating plant on the Unknown River in Labrador. The plant has been inoperative since 1974.

Hydro and its subsidiary and jointly controlled companies, other than Twin Falls, are exempt from paying income taxes under Section 149 (1) (d) of the Income Tax Act.

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Preparation of these consolidated financial statements requires the use of estimates and assumptions that affect the amounts reported and disclosed in these statements and related notes. Key areas where management has made complex or subjective judgements include the fair value and recoverability of assets, litigation, environmental and asset retirement obligations, amortization, property, plant, and equipment and other employee future benefits. Actual results may differ from these estimates, including changes as a result of future decisions made by the Newfoundland and Labrador Board of Commissioners of Public Utilities ("PUB").

Rates and Regulations (Excluding Sales by Subsidiaries)

Hydro's revenues from its electrical sales to most customers within the Province are subject to rate regulation by the PUB. Hydro's borrowing and capital expenditure programs are also subject to review and approval by the PUB. Rates are set through periodic general rate applications utilizing a cost of service ("COS") methodology. The allowed rate of return on rate base is 7.4% (2007 - 7.4%). Hydro applies various accounting policies that differ from enterprises that do not operate in a rate regulated environment. Generally these policies result in the deferral and amortization of costs or credits which will be recovered or refunded in future rates. In the absence of rate regulation these amounts would be included in the determination of net income in the year the amounts are incurred. The effects of rate regulation on the financial statements are more fully disclosed in Note 4.

Principles of Consolidation

The consolidated financial statements include the financial statements of Hydro and its subsidiary companies, GIPCo., (100% owned) and LCDC, (51% owned). Intercompany transactions and balances have been upon consolidation.

Effective June 18, 1999, Hydro, Churchill Falls and Hydro-Québec entered into a shareholders' agreement which provided, among other matters, that certain of the strategic operating, financing and investing policies of Churchill Falls be subject to approval jointly by representatives of Hydro and Hydro-Québec. Although Hydro retains its 65.8%

1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

Principles of Consolidation (cont'd.)

ownership interest, the agreement changed the nature of the relationship between Hydro and Hydro-Québec, with respect to Churchill Falls, from that of majority and minority shareholders, respectively, to that of joint venturers. Accordingly, Hydro has adopted the proportionate consolidation method of accounting for its interest in Churchill Falls subsequent to the effective date of the shareholders' agreement.

A portion of Hydro's shareholding in Churchill Falls was deposited in a voting trust pursuant to an agreement with Hydro-Québec, in relation to Churchill Falls' General Mortgage Bonds. Effective February 25, 2008, the bonds were retired, removing the requirement for the shares to be held in trust.

Churchill Falls holds 33.33% of the equity share capital of Twin Falls and is a party with other shareholders in a participation agreement which gives Churchill Falls joint control of Twin Falls. This investment is accounted for by the proportionate consolidation method.

Cash and Cash Equivalents and Short-Term Investments

Cash and cash equivalents and short-term investments consist primarily of Canadian treasury bills and bankers' acceptances. Those with original maturities at date of purchase of three months or less are classified as cash equivalents whereas those with original maturities beyond three months and less than twelve months are classified as short-term investments. Both are stated at cost, which approximates market value. The short-term investments bear interest rates of 1.58% to 3.60% (2007 - 4.12% to 5.00%) per annum.

Fuel and Supplies

Fuel and supplies inventories are recorded at the lower of average cost or net realizable value.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost, which comprises materials, labour, contracted services, other costs directly related to construction and an allocation of certain overhead costs. Expenditures for additions and betterments are capitalized and normal expenditures for maintenance and repairs are charged to operations. The cost of property, plant and equipment under construction is transferred to property, plant and equipment in service when construction is completed and facilities are commissioned, at which point amortization commences.

The fair value of the future expenditures required to settle legal obligations associated with the retirement of property, plant and equipment, are recognized to the extent that they are reasonably estimable. Asset retirement obligations are recorded as a liability at fair value, with a corresponding increase to property, plant and equipment. As it is expected that Hydro's assets will be used for an indefinite period, no removal date can be determined and consequently, a reasonable estimate of the fair value of any related asset retirement obligation cannot be determined at this time. If it becomes possible to estimate the fair value of the cost of removing assets that Hydro is legally required to remove, an asset retirement obligation will be recognized at that time.

Contributions in aid of construction are funds received from customers and governments toward the incurred cost of property, plant and equipment, or the fair value of assets contributed. Contributions are treated as a reduction to property, plant and equipment and the net property, plant and equipment is amortized.

1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

Property, Plant and Equipment (cont'd.)

Hydro

Construction in progress includes the costs incurred in preliminary feasibility studies, engineering and construction of new generation, transmission and distribution facilities. Interest is charged to construction in progress at rates equivalent to the weighted average cost of capital.

Gains or losses on the disposal of property, plant and equipment are recognized in income as incurred.

Amortization is calculated on hydroelectric generating plant and on transmission plant in service on the sinking fund method using interest factors ranging from 5.25% to 15.79%. Amortization on other plant in service is calculated on the straight-line method. These methods are designed to fully amortize the cost of the facilities, after deducting contributions in aid of construction, over their estimated service lives.

Estimated service lives of the major assets are as follows:

Generation plant	
Hydroelectric	50, 75 and 100 years
Thermal	25 and 30 years
Diesel	20 years
Transmission	
Lines	40 and 50 years
Switching stations	40 years
Distribution system	30 years
Other	3 to 50 years

Hydroelectric generation plant includes the powerhouse, turbines, governors, and generators, as well as water conveying and control structures, including dams, dykes, tailrace, penstock and intake structures. Thermal generation plant is comprised of the powerhouse, turbines and generators, boilers, oil storage tanks, stacks, and auxiliary systems. Diesel generation plant includes the buildings, engines, generators, switchgear, fuel storage and transfer systems, dykes and liners, and cooling systems.

Transmission lines include the support structures, foundations and insulators associated with lines at voltages of 230, 138 and 69 kV. Switching stations assets are used to step up voltages of electricity from generating to transmission and to step down voltages for distribution.

Distribution system assets include poles, transformers, insulators, and conductors.

Other assets would include telecontrol, computer software, buildings, vehicles, furniture, tools and equipment.

Churchill Falls

Churchill Falls uses the group amortization method for certain property, plant and equipment other than the generation plant, transmission and terminals and service facilities.

1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

Property, Plant and Equipment (cont'd.)

Amortization is calculated on a straight-line basis over the following estimated useful lives:

Hydroelectric generation plant	67 years
Transmission and terminals	67 years
Service facilities	67 years
Other	5 to 100 years

Losses on other than normal retirements are charged to operations in the year incurred as adjustments to amortization expense.

Impairment of Long-Lived Assets

Hydro reviews the carrying value of its property, plant and equipment whenever events or changes in circumstances indicate that the expected undiscounted net cash flows could be lower than the carrying value of the property and assets. An impairment loss corresponding to the amount by which the carrying value exceeds fair value is recognized, if applicable.

Revenue Recognition

Revenue is recognized on the accrual basis, as power deliveries are made, and includes an estimate of the value of electricity consumed by customers in the year, but billed subsequent to year-end. Sales within the Province are primarily at rates approved by the PUB. Sales to Hydro-Québec and certain major industrial customers are at rates under the terms of applicable contracts.

A power contract with Hydro-Québec, dated May 12, 1969 ("Power Contract") provides for the sale of substantially all the energy from the Churchill Falls Project until 2041. The Power Contract has a 40-year term to 2016 which then renews for a further term of 25 years. The base rate is predetermined in the Contract and decreases from the existing rate of 2.5425 mills per kWh to 2.0 mills per kWh upon renewal in 2016.

Churchill Falls receives revenues from Hydro-Québec, under a guaranteed winter availability contract ("GWAC") through 2041. The GWAC provides for the sale of 682 MW of additional availability to Hydro-Québec during the months of November through March in each of the remaining years until the end of the Power Contract.

The value of differences between energy delivered and the Annual Energy Base ("AEB"), as defined in the Power Contract, are tracked over a four year period and then either recovered from or refunded to Hydro-Québec over the subsequent four year period, unless the balance is less than $1.0 million in which case it is recovered or refunded immediately. These long-term receivables or long-term payables are subject to interest at 7% per annum (2007 - 7%).

Foreign Currency Translation

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.

1. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

Foreign Currency Translation (cont'd.)

(b) At the date of settlement and at each balance sheet date monetary assets and liabilities are adjusted to reflect exchange rates in effect at that date. Any resulting gain or loss is reflected in income.

(c) Foreign exchange gains and losses are included in income in the current year except for unrealized gains and losses related to First Mortgage Bonds which were recoverable under the Power Contract.

Employee Future Benefits

Employees participate in the Province's Public Service Pension Plan, a multi-employer defined benefit plan. The employer's contributions are expensed as incurred.

Hydro provides group life insurance and health care benefits on a cost-shared basis to retired employees, in addition to a severance payment upon retirement. The expected cost of providing these other employee future benefits is accounted for on an accrual basis and has been actuarially determined using the projected benefit method prorated on service and management's best estimate of salary escalation, retirement ages of employees and expected health care costs. The excess of net cumulative actuarial gains and losses over 10% of the accrued benefit obligation are amortized over the expected average remaining service life of the employee group, which is approximately 13 years.

2. CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2008, Hydro adopted the following new accounting standards issued by the Canadian Institute of Chartered Accountants ("CICA").

Inventories

Section 3031, Inventory requires inventories to be measured at the lower of cost or net realizable value; disallows the use of last-in-first-out inventory costing methodology; and requires that, when circumstances which previously caused inventories to be written down no longer exist, the amount of the write-down is to be reversed. This new standard did not have any impact on Hydro's financial results or disclosures.

Disclosure and Presentation of Financial Instruments

Section 3862, Financial Instruments, Disclosures and Section 3863, Financial Instruments, Presentation sets out new accounting recommendations for disclosure and presentation of financial instruments. The new recommendations require disclosure of both quantitative and qualitative information that enables users of financial statements to evaluate the nature and extent of exposure to risks from financial instruments. These new standards did not have any impact on Hydro's financial results. The additional disclosure is included in Note 14.

Capital Disclosures

Section 1535, Capital Disclosures requires Hydro to include additional information in the notes to the financial statements about its capital and the manner in which it is managed. This additional disclosure includes quantitative and qualitative information regarding objectives, policies and processes for managing capital. The additional required disclosure is provided in Note 12 to these financial statements.

3. PROPERTY, PLANT AND EQUIPMENT

(millions of dollars)	Property Plant and Equipment in Service	Contributions in aid of Construction	Accumulated Amortization	Construction in Progress	Net Book Value
			2008		
Generation plant					
Hydroelectric	**1,364.7**	**20.5**	**325.5**	**1.5**	**1,020.2**
Thermal	**247.5**	**0.8**	**190.6**	**1.9**	**58.0**
Diesel	**62.1**	**6.0**	**31.7**	**0.8**	**25.2**
Transmission and distribution	**781.2**	**60.2**	**245.3**	**4.2**	**479.9**
Service facilities	**22.0**	**-**	**11.4**	**-**	**10.6**
Other	**316.6**	**32.4**	**179.8**	**4.1**	**108.5**
	2,794.1	**119.9**	**984.3**	**12.5**	**1,702.4**
(millions of dollars)			2007		
Generation plant					
Hydroelectric	1,363.5	20.5	313.2	114.4	1,144.2
Thermal	244.2	0.8	188.3	0.8	55.9
Diesel	61.3	5.9	29.7	0.1	25.8
Transmission and distribution	767.2	60.7	229.2	0.8	478.1
Service facilities	22.0	-	11.1	-	10.9
Other	306.0	32.0	167.5	4.3	110.8
	2,764.2	119.9	939.0	120.4	1,825.7

At the end of 2008, pursuant to an asset transfer agreement ("the Transfer Agreement") between Hydro and Nalcor Energy ("Nalcor"), Hydro's parent company, $157.2 million of property, plant and equipment was transferred from Hydro to Nalcor for consideration equal to net book value (Note 19(e)).

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION

(millions of dollars)	**2008**	2007	**Remaining Recovery Settlement Period (years)**
Regulatory assets			
Long-term receivable	-	12.1	-
Foreign exchange losses	**71.1**	73.3	34.0
Deferred regulatory costs	**0.2**	0.4	1.0
Deferred major extraordinary repairs	**7.6**	12.3	4.0
Deferred study costs	**0.2**	0.4	1.0
Deferred wind power costs	**0.5**	-	1.0
Total regulatory assets	**79.6**	98.5	
Less current portion	**5.0**	17.2	
	74.6	81.3	
Regulatory liabilities			
Rate stabilization plan	**53.2**	38.3	n/a
Deferred purchased power savings	**0.6**	0.7	19.0
Total regulatory liabilities	**53.8**	39.0	
Less current portion	**22.3**	23.5	
	31.5	15.5	

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd.)

The following is a description of each of the circumstances in which rate regulation affects the accounting for a transaction or event. Regulatory assets represent future revenues associated with certain costs, incurred in current or prior periods, that are expected to be recovered from customers in future periods through the rate-setting process. Regulatory liabilities represent future reductions or limitations of increases in revenues associated with amounts that are expected to be refunded to customers as a result of the rate-setting process. The risks and uncertainties related to regulatory assets and liabilities are subject to periodic assessment. When Hydro considers that the value of these regulatory assets or liabilities are no longer likely to be recovered or repaid through future rate adjustments, the carrying amount is reflected in operations.

Rate Stabilization Plan and Related Long-Term Receivable

Fuel expenses are included in allowed rates on a forecast basis. On January 1, 1986, Hydro, having received the concurrence of the PUB, implemented a rate stabilization plan ("RSP") which primarily provides for the deferral of fuel expense variances resulting from changes in fuel prices, levels of precipitation and load. Adjustments are required in retail rates to cover the amortization of the balance in the plan and are implemented on July 1 of each year. Similar adjustments required in industrial rates are implemented on January 1 of each year.

Pursuant to Order No. P.U. 7 (2002-2003) and Order No. P.U. 40 (2003) RSP balances which accumulated prior to March 31, 2003, were converted to a long-term receivable bearing interest at the weighted average cost of capital to be recovered over a four-year period, which commenced in 2004. The recovery period for industrial customers ended on December 31, 2007 and for the utility customers on June 30, 2008. Any remaining balances were transferred to the current plan. Any subsequent balances accumulating in the RSP including financing charges are to be recovered in the following year, with the exception of hydraulic variation, which will be recovered or refunded at a rate of twenty-five percent of the outstanding balance at year-end. Additionally, a fuel rider is calculated annually based on the forecast fuel price and is added to or subtracted from the rates that would otherwise be in effect.

Hydro recognizes the RSP balances as a regulatory asset or liability based on the expectation that rates will be adjusted annually to provide for the collection from, or refund to, customers in future periods. In the absence of rate regulation, generally accepted accounting principles would require that the cost of fuel be recognized as an operating expense in the period in which it was consumed. In 2008, $9.1 million was recognized (2007 - $31.5 million) in the RSP and $14.9 million (2007 - $8.9 million) was recovered through rates and included in energy sales, with a corresponding cost amortized in fuels expenses.

Foreign Exchange Losses

Hydro incurred foreign exchange losses related to the issuance of Swiss Franc and Japanese Yen denominated debt in 1975 and 1985, respectively, which were recognized when the debt was repaid in 1997. The PUB has accepted the inclusion of realized foreign exchange losses related to long-term debt in rates charged to customers in future periods. Any such loss, net of any gain, is deferred to the time of the next rate hearing for inclusion in the new rates to be set at that time. Accordingly, these losses are recognized as a regulatory asset. In the absence of rate regulation, generally accepted accounting principles would require that Hydro include the losses in operating costs, in each year that the related debt was outstanding to reflect the exchange rates in effect on each reporting date.

Commencing in 2002, the PUB ordered Hydro's deferred realized foreign exchange losses be amortized over a forty-year period. This amortization, of $2.2 million annually, is included in interest expense (Note 15).

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd.)

Deferred Regulatory Costs

Pursuant to Order No. P.U. 8 (2007), the PUB approved the deferral and amortization of external costs associated with Hydro's 2006 General Rate Application in the amount of $0.6 million. These costs are recognized as a regulatory asset. In the absence of rate regulation, generally accepted accounting principles would require that Hydro include these costs in operating costs in the year in which they were incurred. In 2008, $0.2 million (2007 - $0.2 million) of amortization was recognized in operations and administration expenses.

Deferred Major Extraordinary Repairs

In its report dated April 13, 1992, the PUB recommended that Hydro adopt a policy of deferring and amortizing the costs of major extraordinary repairs in excess of $500,000, subject to PUB approval on a case-by-case basis. In 2005, Hydro started an asbestos abatement program at the Holyrood Thermal Generating Station ("HTGS"). This program was carried out over a three-year period. Pursuant to Order No. P.U. 2 (2005) the PUB approved the deferral and amortization of these costs as a major extraordinary repair. Accordingly, the costs incurred in each year of the program were recognized as a regulatory asset which will be amortized over the subsequent five-year period. In 2006, Hydro incurred $2.3 million in expenses to repair a boiler tube failure at the HTGS. Pursuant to Order No. P.U. 44 (2006) the PUB approved the deferral and amortization of these costs as a major extraordinary repair. Accordingly, these costs are being amortized over a five-year period. In 2007 $2.0 million of expenses related to a turbine failure were deferred as a major extraordinary repair. This amount, net of insurance proceeds, has been expensed in 2008 (Note 20). In the absence of rate regulation, generally accepted accounting principles would require that Hydro expense the cost of the asbestos abatement program and the boiler tube repairs in the year in which they were incurred. In 2008, $2.7 million (2007 - $2.1 million) of amortization was recognized in operating costs.

Deferred Wind Power Costs

Pursuant to Order No. P.U. 20 (2008) the PUB has agreed to allow Hydro to defer $0.5 million in costs associated with connecting the wind farms at St. Lawrence and Fermeuse to the Island Interconnected Grid through Newfoundland Power's transmission system and accordingly, these costs have been recognized as a regulatory asset. These costs will be expensed in 2009. In the absence of rate regulation, generally accepted accounting principles would require that Hydro include these costs in operating costs in the year in which they were incurred.

Deferred Study Costs

Pursuant to Order No. P.U. 14 (2004) the PUB directed Hydro to conduct an independent study of the treatment of Newfoundland Power's generation in Hydro's COS, and an independent marginal cost study, and to accumulate these costs in a deferral account to be dealt with at the next general rate application. Pursuant to Order No. P.U. 8 (2007), Hydro received approval for recovery of these costs over a three year period commencing in 2007. Accordingly, these costs have been recognized as a regulatory asset. In the absence of rate regulation, generally accepted accounting principles would require that Hydro include the cost of these studies in operating costs in the year in which they were incurred. In 2008, there were no additions (2007 - $0.2 million) and $0.2 million (2007 - $0.1 million) of amortization was recognized in operating and administration expenses.

Deferred Purchased Power Savings

In 1997, Hydro interconnected communities in the area of L'Anse au Clair to Red Bay to the Hydro-Québec system. In its report dated July 12, 1996, the PUB recommended that Hydro defer the benefits of a reduced initial purchased power rate, to be amortized over a 30-year period. These savings in the amount of $0.6 million (2007 - $0.7 million) are recognized as a regulatory liability. In the absence of rate regulation, generally accepted accounting principles would require that Hydro include the actual cost of purchased power in operating costs in the year in which they were incurred.

4. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION (cont'd.)

Property, Plant and Equipment

The PUB permits an allowance for funds used during construction ("AFUDC"), based on Hydro's weighted average cost of capital, to be included in the cost of capital assets and amortized over future periods as part of the total cost of the related asset. In 2008, Hydro's AFUDC of 7.6% is higher than its cost of debt of 7.3% the amount capitalized is higher and interest expense is lower by $0.4 million than that which would be permitted in the absence of rate regulation. In 2007, Hydro's AFUDC of 7.6% is lower than its cost of debt of 8.0%, the amount capitalized is lower and interest expense is higher by $0.3 million than that which would be permitted in the absence of rate regulation (Note 15).

Hydro amortizes its hydroelectric generating assets and transmission assets using the sinking fund method, as approved by the PUB. In the absence of rate regulation, these assets would likely be amortized using the straight-line method.

During 2005, Hydro engaged an independent consultant to conduct an amortization study. The scope of this study included a review of Hydro's amortization methods as well as a statistical analysis of service life estimates and calculation of appropriate amortization rates and annual and accrued amortization balances as at December 31, 2004. Based on the results of this study, management currently estimates that accumulated amortization is approximately $170.0 - $180.0 million lower than it would otherwise be, and annual amortization expense is $10.0 - $11.0 million lower, primarily due to the use of sinking fund rather than straight line amortization for hydroelectric and transmission assets. An update to this study began in 2008 and is presently ongoing.

5. LONG-TERM RECEIVABLES

Included in long-term receivables are two refundable deposits in the amount of $25.4 million (2007 - $23.3 million) associated with an application for transmission service into Québec, bearing interest at prime until April, 2007 and at one year Guaranteed Income Certificate ("GIC") rates thereafter. The remaining portion of $1.3 million (2007 - nil is a long-term receivable from Hydro- Québec.

6. INVESTMENTS

(millions of dollars)	**2008**	2007
Lower Churchill Development Corporation Limited	**-**	5.2

LCDC was incorporated in 1978 pursuant to the provisions of an agreement ("Principal Agreement"), between the Province and the Government of Canada. The Province and the Government of Canada own equity interests of 51% and 49% of LCDC, respectively. The Principal Agreement provides that future issues of Class A common shares shall preserve, as nearly as possible, this ratio of beneficial ownership. Hydro is the designate for the Province's shareholding in LCDC.

Pursuant to the provisions of the Principal Agreement, Newfoundland agreed to enter into an Option Agreement, dated November 24, 1978, with LCDC in respect of the GIPCo. assets and the hydroelectric development rights to the Lower Churchill River, (the Water Rights). In consideration of the option granted from the Province, LCDC issued 520 Class A common shares to Hydro, valued at $5.2 million.

The option provided that upon agreement to continue with the Project, LCDC would have acquired the GIPCo. assets for the amount of $94.8 million ($100.0 million less the amount of $5.2 million representing the shares issued pursuant to the signing of the Option Agreement). A 10% convertible demand debenture in the amount of $94.8 million would

6. INVESTMENTS (cont'd.)

have been issued as consideration for the GIPCo. assets and LCDC would have acquired the Water Rights from the Province with the consideration having been the issue of 3,000 Class B common shares without nominal or par value. On November 20, 2008, LCDC was advised by the Province that it would not be extending the Option Agreement. As a consequence, LCDC's option expired on November 24, 2008, which had the effect of terminating the Option Agreement and Hydro's share of the option in the amount of $2.7 million was expensed as an asset write-down in 2008 and the liability to the Government of Canada for non controlling interest in the amount of $2.5 million was eliminated.

Hydro holds 1,540 Class A common shares of LCDC which have a stated value of $10,000 each. Five hundred and twenty shares were acquired in 1979 pursuant to signing of the Option Agreement and five hundred and ten shares were acquired in each of the years 1980 and 1981, by way of capital contributions from the Province.

7. JOINT VENTURE

The following amounts included in the consolidated financial statements represent Hydro's proportionate share of Churchill Falls' assets and liabilities at December 31, 2008, and its proportionate interest in Churchill Falls' operations for the year ended December 31, 2008.

(millions of dollars)	**2008**	2007
Current assets	**37.0**	39.5
Long-term assets	**334.2**	328.9
Current liabilities	**10.5**	12.5
Long-term liabilities	**29.3**	36.6
Revenues	**65.3**	70.6
Expenses	**50.3**	51.0
Net Income	**15.0**	19.6
Cash provided by (used in)		
Operating activities	**30.4**	40.4
Financing activities	**(12.9)**	(19.7)
Investing activities	**(20.0)**	(16.3)

Income tax expense in the amount of $0.2 million (2007 - $0.2 million) related to a jointly controlled subsidiary, Twin Falls has been grouped with operating expenses.

8. LONG-TERM DEBT

Summary of long-term debt	**Hydro**	**Churchill Falls**	**Total**	Hydro	Churchill Falls	Total
(millions of dollars)		**2008**			2007	
Long-term debt	**1,154.7**	**30.1**	**1,184.8**	1,359.4	37.5	1,396.9
Less current portion	**8.3**	**0.8**	**9.1**	208.3	0.8	209.1
	1,146.4	**29.3**	**1,175.7**	1,151.1	36.7	1,187.8

8. LONG-TERM DEBT (cont'd.)

Required repayments of long-term debt and sinking fund requirements over the next five years will be as follows:

(millions of dollars)	**2009**	**2010**	**2011**	**2012**	**2013**
Sinking fund requirements	8.2	8.2	8.2	8.2	8.2
Long-term debt repayments	0.9	29.3	-	-	-
	9.1	37.5	8.2	8.2	8.2

Details of long-term debt are as follows:

Hydro

Series	**Face Value**	**Coupon Rate %**	**Year of Issue**	**Year of Maturity**			
(millions of dollars)					**2008**	2007	
AA	200.0	5.50	1998	2008	-	199.9	
V	125.0	10.50	1989	2014	**124.5**	124.4	(a)
X	150.0	10.25	1992	2017	**149.1**	149.0	(a)
Y	300.0	8.40	1996	2026	**292.9**	292.7	(a)
AB	300.0	6.65	2001	2031	**306.9**	307.1	(a)
AD	125.0	5.70	2003	2033	**123.5**	123.5	(a)
AE	225.0	4.30	2006	2016	**223.5**	223.3	
Total debentures	1,425.0				**1,220.4**	1,419.9	
Less sinking fund investments in own debentures					**65.9**	60.8	
					1,154.5	1,359.1	
Other					**0.2**	0.3	
					1,154.7	1,359.4	
Less payments due within one year					**8.3**	208.3	
					1,146.4	1,151.1	

(a) Sinking funds have been established for these issues.

Sinking fund investments consist of bonds, debentures, promissory notes and coupons issued by, or guaranteed by, the Government of Canada or any province of Canada, and have maturity dates ranging from 2013 to 2033. Hydro debentures which Management intends to hold to maturity are deducted from long-term debt while all other sinking fund investments are shown separately on the balance sheet as assets. Annual contributions to the various sinking funds are as per bond indenture terms, and are structured to ensure the availability of adequate funds at the time of expected bond redemption. Effective yields range from 4.50% to 9.86% (2007 - 4.50% to 9.86%).

Promissory notes, debentures and long-term loans are unsecured and unconditionally guaranteed as to principal and interest and where applicable, sinking fund payments, by the Province. The Province charges Hydro a guarantee fee of 1% annually on the total debt (net of sinking funds) guaranteed by the Province, outstanding as of the preceding December 31. During 2008, the Province waived the payment of this fee.

Hydro uses promissory notes to fulfill its short-term funding requirements. At year-end the promissory notes outstanding were at interest rates ranging from 1.40% to 2.90% (2007 – 4.30% to 4.45%).

8. LONG-TERM DEBT (cont'd.)

Hydro (cont'd.)

Hydro maintains a $50.0 million Canadian or US equivalent unsecured operating credit facility with its banker and at year end, there were no amounts drawn on the facility (2007 - nil). Advances may take the form of a prime rate advance or the issuance of a Bankers' Acceptance ("BA") with interest calculated at the prime rate or prevailing Government BA fee. The facility also provides coverage for overdrafts on Hydro's bank accounts, with interest calculated at the prime rate. At year end, Hydro had two letters of credit outstanding (Note 18(f)) reducing the availability of the credit facility by $7.5 million.

Churchill Falls

(millions of dollars)	**2008**	2007
General Mortgage Bonds		
7.5% due December 15, 2010	**-**	37.5
Less: current portion	**-**	0.8
Total long-term debt	**-**	36.7
Bank of Nova Scotia Credit Agreement		
4.4% due December 15, 2010	**30.1**	-
Less: current portion	**0.8**	-
Total long-term debt	**29.3**	-

Refinancing

On February 25, 2008 Churchill Falls completed a refinancing of the General Mortgage Bonds. The General Mortgage Bonds, bearing an interest rate of 7.5% (6.0% net of subsidies) were retired and replaced with a 4.4% fixed rate credit agreement with the Bank of Nova Scotia. Principal repayment terms of the new credit agreement are the same as those required by the General Mortgage Bonds which provided for semi-annual payments in an amount equal to 1.0% of the aggregate principal amount outstanding on January 1 preceding each payment date with a final principal payment due in 2010.

Churchill Falls exercised its prepayment privileges under the new credit agreement by prepaying $10.0 million principal on March 25, 2008. Hydro's share of this repayment was $6.6 million.

Dividend Restriction

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. A shareholders' agreement signed in June 1999 places additional restrictions on dividends based on cash flow.

Operating Credit Facility

Churchill Falls maintains a $10.0 million Canadian or US equivalent unsecured operating credit facility with its banker and at year end, there were no amounts drawn on the facility (2007 - $0.3 million). Advances may take the form of a Prime Rate advance or the issuance of a BA's with interest calculated at the Prime Rate or prevailing Government BA fee. The facility provides coverage for overdrafts on Churchill Falls' bank accounts, with interest calculated at the Prime Rate. At year end, Churchill Falls had two letters of credit outstanding (Note 18(f)) reducing the availability of the credit facility by $1.4 million.

9. LONG-TERM PAYABLE

The long-term payable to Hydro-Québec as of December 31, 2008 is the accumulation of differences between energy delivered monthly and the AEB energy billed monthly, which will be tracked during the four-year period from September 1, 2008 to August 31, 2012. Currently, the full amount of $0.7 million (2007 - nil) is long-term. The final amount will be determined on August 31, 2012 and will be paid/collected monthly beginning September 2012 and ending August 2016.

10. EMPLOYEE FUTURE BENEFITS

Pension Plan

Employees participate in the Province's Public Service Pension Plan, a multi-employer defined benefit plan. The employer's contributions of $4.6 million (2007 - $4.6 million) are expensed as incurred.

Other Benefits

Additionally, Hydro provides group life insurance and healthcare benefits on a cost-shared basis to retired employees, and in certain cases, their surviving spouses, in addition to a severance payment upon retirement. In 2008, cash payments to beneficiaries for its unfunded other employee future benefits was $3.0 million (2007 - $2.3 million). The most recent actuarial valuation was performed as at December 31, 2006 with an extrapolation of the December 31, 2006 valuation to December 31, 2008. The next actuarial valuation will be performed as at December 31, 2009.

(millions of dollars)	**2008**	2007
Accrued benefit obligation		
Balance at beginning of year	**68.6**	67.8
Transfer to Nalcor (Note 19)	**(1.4)**	-
Current service cost	**2.1**	2.3
Interest cost	**3.7**	3.6
Actuarial gain	**(18.9)**	(2.8)
Benefits paid	**(3.0)**	(2.3)
Balance at end of year	**51.1**	68.6
Plan deficit	**51.1**	68.6
Unamortized actuarial loss	**(0.5)**	(20.9)
Unamortized past service cost	**(0.2)**	(0.3)
Transfer to Nalcor (Note 19)	**(0.5)**	-
Accrued benefit liability at end of year	**49.9**	47.4

(millions of dollars)	**2008**	2007
Components of benefit cost		
Current service cost	**2.1**	2.3
Interest cost	**3.7**	3.6
Actuarial gain	**(18.9)**	(2.8)
	(13.1)	3.1
Adjustments		
Difference between actual actuarial gain and amount recognized	**20.0**	4.3
Benefit expense	**6.9**	7.4

10. EMPLOYEE FUTURE BENEFITS (cont'd)

The significant actuarial assumptions used in measuring the company's accrued benefit obligations and benefit expense are as follows:

	2008	2007
Discount rate	**7.5%**	5.5%
Rate of compensation increase	**3.5%**	3.5%

Assumed health care trend rates:

	2008	2007
Initial health care expense trend rate	**7.0%**	8.0%
Cost trend decline to	**5.0%**	5.0%
Year that rate reaches the rate it is assumed to remain at	**2011**	2011

A 1% increase in assumed health care trend rates would have had the following effect:

(millions of dollars)	**2008**	2007
Current service and interest cost	**1.2**	1.2
Accrued benefits obligation	**6.9**	11.9

A 1% decrease in assumed health care trend rates would have had the following effect:

(millions of dollars)	**2008**	2007
Current service and interest cost	**(0.8)**	(0.8)
Accrued benefits obligation	**(5.5)**	(9.2)

11. SHAREHOLDER'S EQUITY

Share Capital

(millions of dollars)	**2008**	2007
Common shares of par value $1 each		
Authorized 25,000,000 shares; issued 22,503,942 shares	**22.5**	22.5

Contributed Capital

(millions of dollars)	**2008**	2007
Total contributed capital	**111.8**	114.0

The contributed capital related to the Muskrat Falls project was transferred to Nalcor as at December 31, 2008 pursuant to the Transfer Agreement (Note 19(e)).

12. CAPITAL MANAGEMENT

Hydro

Hydro's primary objectives when managing capital are to minimize Hydro's cost of capital within the confines of established risk parameters, and to safeguard Hydro's ability to continue as a going concern. Hydro requires access to capital due to the capital intensive nature of the business which is required to ensure the continued delivery of safe and reliable service to its customers.

12. CAPITAL MANAGEMENT (cont'd.)

Hydro (cont'd.)

The capital managed by Hydro is comprised of debt (long-term debentures, promissory notes, bank credit facilities and bank indebtedness) and equity (share capital, contributed capital, accumulated other comprehensive income and retained earnings).

Hydro's approach to capital management encompasses various factors including monitoring the percentage of floating rate debt in the total debt portfolio, the weighted average term to maturity of its overall debt portfolio, its percentage of debt to debt plus equity and its earnings before interest and taxes ("EBIT") coverage of interest. Adjustments to the capital structure are accomplished through adjustments to the amount of dividends paid to the shareholder, cash infusion via contributed equity and new debt issuance or debt issuance with differing characteristics. Hydro's goal is to achieve a capital structure and cash flow to support debt.

A summary of the capital structure is outlined below:

(millions of dollars)	**2008**		2007	
Debt				
Long-term debt	**1,175.7**		1,187.8	
Current portion of long-term debt	**9.1**		209.1	
Promissory notes	**163.0**		7.0	
Sinking funds	**(163.9)**		(151.8)	
	1,183.9	**66.4%**	1,252.1	64.9%
Equity				
Share capital	**22.5**		22.5	
Contributed capital	**111.8**		114.0	
Accumulated other comprehensive income	**16.5**		19.5	
Retained earnings	**448.0**		521.8	
	598.8	**33.6%**	677.8	35.1%
Total debt and equity	**1,782.7**	**100.0%**	1,929.9	100.0%

Churchill Falls

Churchill Falls' objective when managing capital is to maintain its ability to continue as a going concern. Churchill Falls' requirements for capital in the future are expected to increase, coincident with the aging of the plant and related infrastructure. The focus of the capital management policy is to provide flexibility to ensure cash continues to be available to satisfy capital requirements. Managing the level of dividend payments is a key aspect of ensuring the availability of funding to maintain the plant and infrastructure.

At present, the capital position of the Churchill Falls is weighted heavily toward equity capital (share capital and retained earnings). The only remaining long-term debt at the end of the year consisted of a loan from the Bank of Nova Scotia, the balance of which comprised less than 10% of the total capital structure. This loan carries the same terms of repayment as the former General Mortgage Bonds and will mature in December of 2010, with any remaining principal due at that time. The Company has the right to prepay under certain conditions and has already taken advantage of the opportunity to do so. On March 19, 2008 Churchill Falls exercised its prepayment rights under the Credit Agreement to prepay $10.0 million in principal effective March 25, 2008. The corporate strategy is to ensure that funding is in place to extinguish the entire debt by the end of 2010 without re-financing. The capital structure is adjusted through the amount of dividends paid to shareholders.

13. ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in the fair value of sinking fund and reserve fund investments comprise the items in other comprehensive income.

(millions of dollars)	**2008**	2007
Balance, beginning of year	**19.5**	-
Adjustment due to the adoption of new accounting policies	**-**	19.3
Change in fair value of sinking fund investments	**(3.6)**	0.2
Change in fair value of reserve fund investments	**0.6**	-
Balance, end of year	**16.5**	19.5

14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Hydro has classified its financial instruments as follows:

Cash and cash equivalents	Held-for-trading
Short-term investments	Held-to-maturity
Accounts receivable	Loans and receivables
Sinking funds - investments in same Hydro issue	Held-to-maturity
Sinking funds - other investments	Available for sale
Reserve fund	Available for sale
Long-term receivable	Loans and receivables
Bank indebtedness	Other liabilities
Accounts payable and accrued liabilities	Other liabilities
Promissory notes	Other liabilities
Long-term debt	Other liabilities
Due to related parties	Other liabilities

Each of these financial instruments is measured at amortized cost, except for the reserve fund, sinking fund – other investments and cash and cash equivalents which are measured at fair value.

In 2007, Hydro recognized an increase to opening retained earnings of $2.3 million resulting from the measurement of outstanding long-term debt at amortized cost, using the effective interest method. As well, Hydro recognized an opening balance of accumulated other comprehensive income arising from unrealized gains on sinking fund investments of $19.3 million.

Fair Value

The estimated fair values of financial instruments as at December 31, 2008 are based on relevant market prices and information available at the time. The fair value of long-term debt is estimated based on the quoted market price for the same or similar debt instruments. The fair value estimates below are not necessarily indicative of the amounts that Hydro might receive or incur in actual market transactions. As a significant number of Hydro's assets and liabilities, including fuels and supplies and property, plant and equipment, do not meet the definition of financial instruments, the fair value estimates below do not reflect the fair value of Hydro as a whole.

	Carrying Value	**Fair Value**	Carrying Value	Fair Value
(millions of dollars)	**2008**		2007	
Long-term debt including current portion	**1,184.8**	**1,484.8**	1,396.9	1,731.2

14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)

Fair Value (cont'd.)

Transaction costs related to financial assets and financial liabilities are included as part of the cost of the instrument, with the exception of cash and cash equivalents which are expensed as incurred, based upon the pricing obtained during the quotation process. Discounts and premiums on financial instruments are amortized to income over the life of the instrument.

Risk Management

Exposure to credit risk, liquidity risk and market risk arises in the normal course of Hydro's business.

Hydro

(a) Credit Risk

Hydro is exposed to credit risk in the event of non performance by counterparties to its financial instruments. The majority of Hydro's receivables are from regulated utilities which minimizes credit risk. There is risk that Hydro will not be able to collect all of its remaining accounts receivable and amounts owing under its customer finance plans. These financial instruments which arise in the normal course of business do not represent a significant concentration of credit risk as amounts are owed by a large number of customers on normal credit terms. Hydro manages this credit risk primarily by executing its credit and collection policy including the requirement for security deposits from certain customers.

Hydro manages its investment credit risk exposure by restricting its investments to high quality securities such as Canada Treasury Bills, Bankers' Acceptances drawn on Schedule 1 Canadian Chartered Banks and Term Deposits issued by Schedule 1 Canadian Chartered Banks.

(b) Liquidity Risk

Hydro is exposed to liquidity risk with respect to its contractual obligations and financial liabilities. Hydro manages this risk by maintaining borrowing facilities sufficient to cover both anticipated and unexpected fluctuations within the operations and by continuously monitoring cashflows. Short-term liquidity is provided through cash and cash equivalents on hand, funds from operations, a $300.0 million promissory note program and a $50.0 million operating credit facility. Long-term liquidity risk is managed by the issuance of a portfolio of debentures with maturity dates ranging from 2014 to 2033. Sinking funds have been established for these issues.

(c) Market Risk

Market risk refers primarily to the risk of loss resulting from changes in interest rates, commodity prices and foreign exchange rates.

<u>Interest Rates</u>
Interest rate risk is managed within the corporate financing strategy where floating rate debt exposures and interest rate scenarios are forecast and evaluated. A diversified portfolio of fixed and floating rate debt is maintained and managed with a view to an acceptable risk profile. Key quantitative parameters for interest rate risk management are the percentage of floating rate debt in the total debt portfolio, coupled with an examination of the weighted average term to maturity of the entire debt portfolio. By setting clear guidelines in respect to these quantitative parameters, Hydro attempts to minimize the likelihood of a material impact on net income resulting from an unexpected change in interest rates.

14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)

Hydro (cont'd)

(d) Market Risk (cont'd.)

Interest Rates (cont'd.)
Exposure to changes in interest rates exists on interest expense related to the short-term debt portfolio and interest income related to the sinking fund investment portfolios. Hydro estimates that an increase of 100 basis points from the actual average yield on the short-term debt portfolio in 2008 would have resulted in a change in interest expense of $1.3 million (2007 - $0.2 million). Similarly, an increase of 100 basis points from the actual average yield on the sinking fund investment portfolio in 2008 would have resulted in a change in interest income of $2.0 million (2007 - $1.8 million) and a decrease in other comprehensive income of $16.1 million (2007 - $16.1 million). Interest rate risk on the long-term debt portfolio is mitigated through the use of fixed rate debentures.

Foreign Currency and Commodity Exposure
Fair value of future cash flows of a financial instrument will fluctuate due to changes in the exchange rate between the foreign currency and the Canadian dollar. Hydro's primary exposure to both foreign exchange and commodity price risk arise from its purchases of No. 6 fuel for consumption at the HTGS.

During 2008, Hydro had total purchases of No. 6 fuel of $103.9 million (2007 - $122.0 million). These purchases are denominated in U.S. dollars.

Hydro's exposure to both the foreign exchange and commodity price risk associated with these purchases is mitigated through the operation of the RSP. The purpose of the RSP is to both reduce volatility in customer rates as well as mitigate potential net income volatility from fuel price and volume variations. All variances in actual fuel prices and exchange rates as compared to that approved in Hydro's most recent COS used to set rates, are captured in the RSP and are either refunded to or collected from customers via automatic rate adjustments. Hydro also employs the periodic use of forward currency contracts as a means by which exposure to exchange rates on a particular day can be avoided. As at December 31, 2008 there were no forward contracts outstanding.

Churchill Falls

(a) Liquidity Risk

Churchill Falls is exposed to liquidity risk with respect to its contractual obligations and financial liabilities. Churchill Falls manages this risk by maintaining borrowing facilities sufficient to cover both anticipated and unexpected fluctuations within its operations and by continuously monitoring cash flows. Short-term liquidity is provided through cash and cash equivalents on hand, funds from operations and the $10.0 million unsecured credit facility. Long-term liquidity risk is managed by maintenance of the reserve fund in accordance with the June 1999 shareholders' agreement and dividend management policy to meet long term liquidity requirements associated with debt retirement and the company's capital expenditure program.

(b) Market Risk

Market risk refers primarily to the risk of loss resulting from changes in commodity prices, foreign exchange rates and interest rates.

14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd.)

Churchill Falls (cont'd)

(b) Market Risk (cont'd.)

Interest Rates
Interest rate risk is mitigated on the company's long-term debt by virtue of a fixed interest rate to maturity. Exposure to changes in interest rates exists on investment income related to the short-term and reserve fund investment portfolios. Churchill Falls estimates that an increase of 100 basis points from the actual average yield earned on the short-term investment portfolio in 2008 would have resulted in a change in interest income of $0.2 million (2007 - $0.2 million). Similarly, an increase of 100 basis points from the actual average yield earned on the reserve fund investment portfolio in 2008 would have resulted in a change in interest income of $0.2 million (2007 - $0.1 million) and an increase in other comprehensive income of $0.5 million (2007 - $0.2 million). Interest rate risk is managed within the corporate financing strategy whereby floating rate debt exposures and interest rate scenarios are forecast and evaluated.

Foreign Currency Exposure
The fair value or future cash flows of a financial instrument will fluctuate due to changes in foreign exchange rate between a foreign currency and the Canadian dollar. Churchill Falls is exposed to foreign exchange risk when it enters into transactions to procure goods and services denominated in a foreign currency however this exposure to foreign exchange rate fluctuations is immaterial.

Commodity
Churchill Falls does not hold any financial instrument whose value would vary due to changes in a commodity price.

15. INTEREST EXPENSE

(millions of dollars)	**2008**	2007
Gross interest		
Long-term debt	**96.0**	105.0
Promissory notes	**4.2**	0.9
	100.2	105.9
Accretion of long-term debt	**0.5**	0.8
Provision for foreign exchange losses	**2.2**	2.2
	102.9	108.9
Less		
Recovered from Hydro-Québec	**0.1**	1.0
Interest capitalized during construction	**9.6**	6.3
Interest earned	**14.4**	14.3
Net interest expense	**78.8**	87.3
Debt guarantee fee	**-**	13.1
Net interest and guarantee fee	**78.8**	100.4

Under the terms of the Power Contract, Churchill Falls recovers the difference between interest calculated at the rates prescribed in the Power Contract and interest paid on its long-term debt. In addition, with the refinancing of the General Mortgage Bonds, Churchill Falls is required to share with Hydro-Québec any benefits it receives resulting from the refinancing.

15. INTEREST EXPENSE (cont'd.)

Also, Churchill Falls can request Hydro and Hydro-Québec to make advances against the issue of Subordinated Debt Obligations, to service its debt and to cover expenses if funds are not otherwise available. If such requests fail to attract sufficient advances, Churchill Falls can require Hydro-Québec 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 that remain unfunded.

16. CHANGE IN NON-CASH WORKING CAPITAL BALANCES

(millions of dollars)	**2008**	2007
Accounts receivable	**3.6**	(7.8)
Fuel and supplies	**17.0**	(15.3)
Prepaid expenses	**(0.4)**	0.3
Accounts payable and accrued liabilities	**(20.8)**	26.7
Regulatory assets	**18.9**	49.7
Regulatory liabilities	**14.8**	(11.3)
Accrued interest	**(2.0)**	(0.1)
Employee future benefits	**3.0**	5.1
Long-term receivable	**(2.9)**	(4.5)
Long-term payable	**0.7**	(0.3)
Due from related parties	**(0.2)**	-
	31.7	42.5

17. SEGMENT INFORMATION

Hydro operates in three business segments. Regulated operations encompass sales of power and energy to most customers within the province of Newfoundland and Labrador while Churchill Falls operates a hydro-electric generating facility and sells electricity primarily to Hydro-Québec. Other energy activities are primarily engaged in sales to markets outside the province. The designation of segments has been based on a combination of regulatory status and management accountability. The segment's accounting policies are the same as those described in Note 1.

Geographic Information

Revenues by geographic area:

(millions of dollars)	**2008**	2007
Newfoundland and Labrador	**447.3**	445.1
Québec	**121.6**	128.3
	568.9	573.4

All of Hydro's assets are located in the Province.

17. SEGMENT INFORMATION (cont'd.)

Segments

(millions of dollars)	Regulated	Other Energy Activities	Churchill Falls	Inter-segment	Total
			2008		
Revenue					
Energy sales	**440.1**	**58.2**	**68.9**	**(3.9)**	**563.3**
Other	**2.2**		**0.3**	**3.1**	**5.6**
	442.3	**58.2**	**69.2**	**(0.8)**	**568.9**
Expenses					
Operations and administration	**99.1**	**3.9**	**38.8**	**-**	**141.8**
Fuels	**164.8**	**-**	**-**	**-**	**164.8**
Power purchased	**41.4**	**3.5**	**-**	**(3.9)**	**41.0**
Amortization	**40.4**	**-**	**11.4**	**1.2**	**53.0**
Interest	**87.6**	**(8.9)**	**0.1**	**-**	**78.8**
Write-down of investment	**-**	**2.7**	**-**	**-**	**2.7**
	433.3	**1.2**	**50.3**	**(2.7)**	**482.1**
Net income before equity in Churchill Falls	**9.0**	**57.0**	**18.9**	**1.9**	**86.8**
Equity in Churchill Falls	**-**	**11.8**	**-**	**(11.8)**	**-**
Preferred dividends	**-**	**9.0**	**-**	**(9.0)**	**-**
Net income	**9.0**	**77.8**	**18.9**	**(18.9)**	**86.8**
Capital expenditures	**45.6**	**40.2**	**4.3**	**-**	**90.1**
Total assets	**1,711.5**	**385.2**	**371.2**	**(322.3)**	**2,145.6**
(millions of dollars)			2007		
Revenue					
Energy sales	438.7	58.5	74.2	(3.9)	567.5
Other	2.0		0.3	3.6	5.9
	440.7	58.5	74.5	(0.3)	573.4
Expenses					
Operations and administration	98.5	6.0	38.6	-	143.1
Fuels	159.2	-	-	-	159.2
Power purchased	38.5	3.9	-	(4.0)	38.4
Amortization	38.4	-	11.2	1.1	50.7
Interest	103.2	(5.0)	2.1	0.1	100.4
Write-down of investment	-	-	-	-	-
	437.8	4.9	51.9	(2.8)	491.8
Net income before equity in Churchill Falls	2.9	53.6	22.6	2.5	81.6
Equity in Churchill Falls	-	14.7	-	(14.7)	-
Preferred dividends	-	10.4	-	(10.4)	-
Net income	2.9	78.7	22.6	(22.6)	81.6
Capital expenditures	36.0	45.7	4.8	-	86.5
Total assets	1,733.3	498.9	368.4	(314.3)	2,286.3

During 2008, sales to Hydro's two largest customers amounted to 60% and 10% of total energy sales revenue (2007 - 60% and 10%). At December 31, 2008 approximately 63.2% (2007 - 59.7%) of the total accounts receivable balance outstanding is due from one customer.

18. COMMITMENTS AND CONTINGENCIES

(a) Under the terms of a sublease with Twin Falls, expiring on December 31, 2014, 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 Twin Falls' plant and equipment. The costs associated with making the plant operational, if required, are not estimable at this time. In 2015, the physical assets of Twin Falls will revert to Churchill Falls, and Churchill Falls is required to make this horsepower available to Hydro at rates that are commercially reasonable pursuant to the 1999 shareholders' agreement.

The results of an Environmental Site Assessment ("ESA") conducted at the Twin Falls Generating Station indicated higher than acceptable concentrations of contaminants in the soil and waters adjacent to the powerhouse. Further testing was conducted to determine the extent of contamination. The recommendations arising from this testing indicate that remediation is not required, but further monitoring be carried out. Further monitoring is recommended for 2010 and every five years thereafter.

(b) Pursuant to the terms of the 1999 shareholders' agreement, in 2007, Churchill Falls commenced the creation of a $75.0 million segregated reserve fund to contribute towards the funding of capital expenditures related to Churchill Falls' existing facilities and their replacement. Churchill Falls invested $17.0 million in each of 2007 and 2008. The remaining investments will be acquired during a 30-day period commencing on each of the following dates:

January 1, 2009	$17.0	million
January 1, 2010	$8.0	million
January 1, 2011	$8.0	million
January 1, 2012	$8.0	million

This fund must remain in place until the end of the shareholders' agreement in 2041. Any amounts removed to fund capital expenditures must be replaced. Reserve fund holding consist of securities issued by the Government of Canada, various provinces of Canada and Schedule 1 Canadian Chartered Accounts. Hydro's share of this commitment is 65.8%.

A summary of Hydro's 65.8% share of the reserve fund is as follows:

(millions of dollars)	**2008**	2007
Opening balance	**11.2**	-
Contribution	**11.2**	11.2
Total contribution to reserve fund	**22.4**	11.2
Net interest earned	**0.4**	0.3
Mark-to-market adjustment	**0.6**	-
Fair value of reserve fund	**23.4**	11.5

(c) Hydro has received claims instituted by various companies and individuals with respect to outages and other miscellaneous matters. Although such matters cannot be predicted with certainty, management currently considers Hydro's exposure to such claims and litigation, to the extent not covered by insurance policies or otherwise provided for, to be $0.2 million (2007 - $1.2 million).

One of Hydro's industrial customers commenced legal proceedings in 1997, claiming approximately $22.2 million (2007 - $21.8 million) related to outages and plant shutdowns. Hydro is defending this claim and management believes that this claim will not be successful.

18. COMMITMENTS AND CONTINGENCIES (cont'd.)

(d) Outstanding commitments for capital projects total approximately $7.1 million (2007 - $16.8 million).

(e) Hydro has entered into a number of long-term power purchase agreements as follows:

Type	Rating	In-Service Date	Term
Hydroelectric	175 kW	1988	Continual
Hydroelectric	3 MW	1995	25 years
Hydroelectric	4 MW	1998	25 years
Cogeneration	15 MW	2003	20 years
Wind	390 kW	2004	15 years
Wind	27 MW	2008	20 years
Wind	27 MW	2009	20 years

During 2008, the enactment of the Abitibi - Consolidated Rights and Assets Act resulted in the cancelation of two long-term power purchase agreements (Note 21).

Estimated payments due in each of the next five years are as follows:

(millions of dollars)	**2009**	**2010**	**2011**	**2012**	**2013**
Power purchases	25.6	26.4	29.6	30.0	30.6

(f) Hydro has issued two irrevocable letters of credit, one in the amount of $7.2 million to New Brunswick System Operator as credit support related to an application for point to point transmission service. The second letter of credit has been issued to the Department of Fisheries and Oceans in the amount of $0.3 million as a performance guarantee in relation to the Fish Habitat Compensation Agreement. Churchill Falls has issued two irrevocable letters of credit, in the amount of $0.7 million each to ensure satisfactory management of its waste management and compliance with a certificate of approval for the transportation of special hazardous wastes, granted by the Department of Environment and Conservation.

19. RELATED PARTY TRANSACTIONS

The Province, Nalcor, Churchill Falls, LCDC and GIPCo. are related parties of Hydro. In addition, the PUB is related to Hydro by virtue of its status as an agency of the Province.

(a) Hydro has entered into a long-term power contract with Churchill Falls for the purchase of $6.0 million (2007 - $6.1 million) of the power produced by Churchill Falls and Hydro's 65.8% share is estimated upon consolidation.

(b) For the year ended December 31, 2008, approximately $1.8 million (2007 - $2.2 million) of operating costs were recovered from Churchill Falls for engineering, technical, management and administrative services. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties and Hydro's 65.8% share is eliminated upon consolidation.

(c) Hydro is required to contribute to the cost of operations of the PUB as well as pay for the cost of hearings into applications it makes. During 2008, Hydro incurred $0.6 million in costs related to the PUB (2007 - $1.2 million) of which $0.1 million (2007 - $0.1 million) was included in accrued liabilities.

(d) Under the terms and conditions of the Churchill Falls (Labrador) Corporation (Lease) Act, 1961, Churchill Falls must pay rentals and royalties to the Province annually.

19. RELATED PARTY TRANSACTIONS (cont'd.)

(e) As at December 31, 2008, certain non-regulated assets and liabilities and the related debt and equity were transferred from Hydro to Nalcor. Details of the transactions are noted below which resulted in a payable of $6.1 million by Hydro to Nalcor. In June, 2008, an advance payment was made by Hydro to Nalcor resulting in a $3.1 million liability as at December 31, 2008 which is recorded in Due to related parties.

(millions of dollars)	**2008**
Capital assets	**157.2**
Contributed capital	**(2.2)**
Employee future benefits	**(0.5)**
Retained earnings from non-regulated activity in Hydro	**(160.6)**
Sub total	**(6.1)**
Payment made in 2008	**3.0**
Total due to Nalcor	**(3.1)**

In addition to the $0.5 million transfer for employee future benefits noted above, in January, 2008, there was a transfer of a $0.9 million liability from Hydro to Nalcor for a total transferred amount of $1.4 million (Note 10).

(f) During 2008, Nalcor advanced $4.5 million as a contribution in aid of construction related to the Ramea Wind-Hydrogen-Diesel Project. As at December 31, 2008, $1.7 million of this funding has not been utilized to cover the costs of the associated capital project and has been recorded as a deferred contribution. Hydro also received contribution in aid of construction from the Province related to wind feasibility studies. As at December 31, 2008, the full amount of $0.5 million has been recorded as a deferred capital contribution.

(g) During 2008, Hydro received $0.4 million (2007 - nil) as a rate subsidy for rural isolated customers from the Province and $1.5 million (2007 - $0.6 million) as an energy rebate to offset the cost of basic electricity consumption for Labrador rural isolated residential customers under the Northern Strategic Plan with $0.1 million (2007 - $0.6 million) recorded as accounts receivable at year end.

20. CHANGE IN ESTIMATE

In 2007, Hydro incurred $2.0 million in expenses to repair a turbine at HTGS and these costs were deferred as a major extraordinary repair. Pursuant to Order No. P.U. 31 (2008) the PUB denied Hydro's request to treat the repair of the turbine as a major extraordinary repair and therefore, the full cost of the repair, net of insurance proceeds of $0.8 million, was recorded in operations and administration expense during 2008.

21. SIGNIFICANT OCCURRENCES

(a) In late 2008, Abitibi Consolidated announced a shut down of the Grand Falls Pulp and Paper Mill resulting in a loss of a major industrial customer. Revenue from Abitibi Grand Falls for the year ended December 31, 2008 was $5.1 million (2007 - $4.9 million). The Abitibi - Consolidated Rights and Assets Act was enacted on December 16, 2008 resulting in the cancellation of two power purchase agreements from two non-utility generator in which Abitibi was a partner.

21. SIGNIFICANT OCCURRENCES (cont'd.)

(b) On November 3, 2008, a fire occurred in a cable shaft at Churchill Falls causing extensive damage to two sets of high voltage cables in two units of the cable shaft.

Repair work has begun on one unit with work expected to be completed in February 2009. The second unit will be repaired in the summer of 2009 once the necessary cables have been obtained. Hydro's estimated share of the cost of the repair to the cables in the amount of $6.6 million is covered by an insurance policy with a $1.3 million deductible. As at December 31, 2008, Hydro's share of expenses totaling $1.5 million have been incurred in relation to this repair and insurance proceeds of $0.2 million have been accrued. Churchill Falls will accrue the expenses and related insurance proceeds as incurred.

Hydro's 65.8% share of the total impact of the fire on net income for the year ended December 31, 2008 including lost revenue is estimated to be as follows:

(millions of dollars)	**2008**
Lost revenue - guaranteed winter availability	(8.4)
Lost revenue - power sales	(2.1)
Repair costs (net of insurance proceeds)	(1.3)
Net decrease in rental and other costs	0.8
Total impact on net income	(11.0)

22. COMPARATIVE FIGURES

Certain of the 2007 comparative figures have been reclassified to conform with the 2008 financial statement presentation.