UNEXPECTED EVENT / UNKNOWN STRATEGIC RISK #1
SLUMPING OIL PRICES AND IMPACT ON SHAREHOLDER FISCAL CAPACITY

Risk Brief

- As illustrated in Figure 10, during the period beginning in mid-2014, oil prices, which had been hovering between $0 to $110 US/bbl, quickly declined, bottoming out at $28 US/bbl in February 2016. Combined with declining oil production, the Province's revenues from oil royalties dropped from the $2 B+ annually to ~$500 M (reference Figure 11), leading to increased deficits.

When did the Risk Manifest itself into a Major Project Issue

- By mid-2014, it was becoming clear that in a low-oil price environment, the Province's fiscal situation was worsening. that Concurrently with the negative impacts on the Province's fiscal capacity, the expected cost to complete the Project was increasing, thus leading to the Shareholder experiencing difficulties with meeting the equity investment requirements that the Province was obligated to provide under the Federal Loan Guarantee (FLG).

Effect on Muskrat Falls Project

a) Ability of the Province to maintain pre-funded equity covenants for Project contained within the Federal Loan Guarantee 1 (FLG1).

- FLG1 was predicated on Canada providing a loan guarantee of $5B of debt required for the Muskrat Falls Project, with the balance of the total $6.2B being funded by equity. All cost over-runs were to be funded by equity from the Province.

- Provisions within the FLG1 Agreement required that equity for any forecasted cost overruns be set aside by the Province in a pre-funded equity escrow account (i.e. COREA provision or Section 4.10 of FLG1 agreement). Interpretation of this provision meant that overly conservative forecasts would result in the Province having to put more of its limited revenue aside (i.e. in escrow) to fund such potential over-runs, or it would be in breach of FLG covenants. All funds placed in escrow for potential use at a later time would deprive the Province of current funds required to fund other Provincial programs.

- In an effort not be too punitive, Canada agreed that such forecasts would represent known, firm costs, such as awarded contracts and settled claims, and not be speculative in-nature by factoring in such elements as opening bid prices or submitted, unattested claims. By doing this, the amounts of funds the Province would have to place in escrow would be reduced, thus aiding their ability to maintain other Provincial programs in this period of reduced oil royalty revenues.

b) Muskrat Falls Project targeted as a drain on the Province's limited fiscal resources.

- The repeated and escalating cost forecasts contributed to public sentiment and perception that the Project was out of control.

- Incoming Liberal government made it clear that cost overruns on Muskrat Falls were a burden to the Province.

Net Consequences

a) **Cost forecasting had to consider the obligations under the COREA (pre-funded equity) provision, thus it would have punitive effects on the Province's fiscal situation if potential costs and not firm costs were provided.**

- Project cost forecasts made public were to reflect known cost over-runs, while future cost risks and trends were characterized as under study and subject to future confirmation and reporting.

- The net result was that public cost forecasts were not risk-adjusted cost forecasts that considered the potential exposure of potential risk items. This led to repeated cost updates and a view that costs were not in control.

- The Province's weakened fiscal situation contributed to the reluctance to communicate early to the public that cost over-runs had occurred, rather as illustrated in Figure 10, there was an extended lag between when Final Forecast Cost (FFC) updates were available and when such information was approved to be shared with the public.

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[12] Reference CBC news article *"It's official: Muskrat Falls a boondoggle, says Stan Marshall"* published 24-Jun-2016.