Information Note
Department of Finance

Title: Muskrat Falls Financing

Issue: To provide an update on the financing for the Muskrat Falls Project

Background:

The Province is moving forward towards a sanction decision of the Muskrat Falls project. Power from the Muskrat Falls generating station on the Lower Churchill in Labrador would be fed to Newfoundland over the Labrador Island Link HvDc transmission line that will cross the Strait of Belle Isle.

The project is primarily a hydroelectric generation plan with 824 MW from a hydroelectric generating station and 670 MW from thermal generating stations. Thermal is used to provide reliability and capacity support to the system and is only used when operational contingencies arise.

For purposes of financing, the project is segregated into Muskrat Falls/Transmission Assets (MF/LTA) and the Labrador Island Link ("LIL") (collectively referred to as the Project)

DG3 estimates the total capital cost of the project at $6.2 billion. This estimate includes MF costs of $2.9B; LTA costs of $0.7B and the LIL at $2.6B. The $6.2B represents the total cost to the Province and Nalcor and excludes interest during construction and financing costs. Note that Emera also plans to invest $1.2B in the Maritime Link for a total estimated project cost of $7.4B. Emera's will release their final cost estimates on the ML in the near term.

The project will be financed through a combination of 1) an equity investment from the Government of Newfoundland and Labrador ("GNL") and 2) project debt financing by Nalcor.

The Nalcor debt will be non-recourse financing. The non-recourse structure will mean the project assets will be pledged as security, but that neither Nalcor nor Government would be liable nor would any non-project assets be at risk in the event of default. This approach is commonly used in the energy and infrastructure sectors, where project sponsors provide the equity and lenders provide non-recourse loans that are serviced from project cash flows; in this case the debt will be serviced from the revenue generated from the sale of Muskrat Falls power.

Financing Process

<u>Commitment Letter</u>

To facilitate the financing of the project, Government provided a commitment letter to Nalcor in October 2011 that outlined its objectives and intentions in support of the project. This letter committed the Government to provide an equity investment in the Project, including the amount determined during the financing process and to provide any additional equity required to ensure project completion.

The Government also committed to ensure that NLH regulated rates provides sufficient revenue in each year to recover all project costs.

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<u>The commitment of the Province was critical in Phase I of Nalor's finance raising process which was completed in November 2011. This process consisted of Nalcor meeting with the rating agencies to receive a shadow credit rating based on all technical and financial project information available at that time (based on DG2 estimates). A shadow credit rating is a confidential credit rating used to get an indication of the level of risk and credit worthiness that capital markets associate with a projects debt. In this first phase, Nalcor received a strong investment grade shadow credit rating from all three rating agencies- S&P, Moody's and DBRS. The rating agencies noted the importance of Government's support in the rating analysis.</u>

<u>Federal Loan Guarantee</u>

The finance process also includes executing a term sheet for a federal loan guarantee ("FLG"). Officials from Nalcor and the Department of Natural Resources along with financial advisors have been engaged in negotiations with the federal government to finalize a federal loan guarantee. The FLG will be a guarantee against the Nalcor project financing debt and will not include any debt that is raised by the Province to finance its equity investment in the project.

The federal loan guarantee will lower the cost of the project debt and these savings will be passed directly to the ratepayers through lower electricity rates. The FLG is nearing completion and details are expected to be finalized in the near term.

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<u>Updated Credit Rating-October 2012</u>

To support a Sanction decision and completion of the FLG, officials from Government and Nalcor met with the rating agencies in October 2012 to obtain an updated credit rating.

Since the November 2011 rating, significant progress was achieved on engineering (now 50% complete); DG3 capital costs have now been finalized, business case has been updated, progress has been made on NL legislative commitments; financing plans have been updated; the federal loan guarantee has progressed and Emera agreements have been finalized. The rating agencies were updated on each of these elements. The rating presentations went well and feedback from the rating agencies on the outcome of the ratings is expected to be received on November 23rd, 2012.

Nalcor Financing Summary

The key elements of the Project debt financing includes:

- Both base and contingent equity provided by the province
- Capital structure for LIL at 75:25 Debt to Equity ratio("DER")
- Capital Structure for the MF/LTA at 65:35 DER

The modeling which has been developed to structure the project debt includes an appropriately sized credit facility to fund ongoing construction requirements and periodic bond issuances throughout the construction phase. Work continues on the assessment of other potential financing options to lower debt servicing costs including an upfront bond.

Nalcor is in consultation with its relationship banks on market conditions and key financing parameters. The financing will be denominated in Canadian dollars. The debt on the MF/LTA will be for 30 years and the LIL debt will be for a term of 50 years.

The path to financial close for the Nalcor Financing includes the following activities:

- ***{CONFIDENTIAL-NOT DISCLOSED PUBLICLY}-* Updated credit ratings resulting from the November 2012 presentations to rating agencies**
- Finalization of the FLG
- NL Undertakings Implemented (Legislation passed in the House)
- MF, LTA and LIL Sanction
- LIL Environmental Assessment Release
- Preparation for and approach to capital markets
- Fundraising process/Final Due Diligence and Agency Ratings
- Financial Close expected Q4 2013

Note that final ratings will be received for the Project before going to the capital market. Note also that certain of the above terms and conditions may be revised as Nalcor progresses towards financial close in Q4 2013.

NL Government Equity Contribution

In addition to the financing process outlined above to obtain the project debt, the GNL has committed to providing the base and contingent equity to complete the project. The Province's equity investment to date is $290 million and cumulative equity investment before financial close (Q4 2013) is expected to be $900 million**.** The total equity requirement is expected to be in the range of $2.0B-$2.2B depending on the financing option chosen. This estimate does not factor in Emera's participation. If we factor in Emera's participation, the equity ***r***equirement would be in the range of $1.6B to $1.8B.

	FLG Tranched Bond	FLG Up Front Bond
Total Equity	$2.4B	$2.6B
Less: AFUDC and Funding Phase Revenue	(0.4)B	(0.4)B
Net Equity without Emera	**$2.0B**	**$2.2B**
Less: Emera Contribution	(0.4) B	(0.4)B
Net Contribution including Emera	**$1.6B**	**$1.8B**
Contributions to Date	$(0.3)B	$(0.3)B
Remaining Contributions	$1.3B	$1.5B

Terms defined:

During the construction period, the Project will likely utilize financing which will accumulate financing costs during the period. These could include:

- **Interest during Construction (IDC)** is a component of construction costs and include the interest cost of debt (i.e. loans) used to finance construction until a project begins operation.

- **Allowance for Funds Used during Construction (AFUDC)** is a component of construction costs that represents the cost of equity funds used to finance construction until a project begins operation.

Government will fund its equity contribution in the project from available cash on hand and debt. Given the Province's favorable credit ratings, its extended absence from the new issuance market (since 2004 for operational purposes), and the known demand for its name, the required amount of debt should be easily accessible through conventional capital markets.

The borrowing approach will be determined as the project proceeds and will include factors such as future cash flow expectations/requirements and probability of cost over-run risks.

It is the clear opinion of the Province's financial advisors that the required funds can be easily raised in Canadian capital markets through the issuance of provincial government bonds of a plain vanilla nature that will appeal to a wide range of potential investors.

The financial analysis also shows that the free cash flow that will be returned to the Province through dividends from the Muskrat Falls project will be more than sufficient to meet debt servicing requirements. The Muskrat Falls Project will diversify the province's revenue base with a renewable stable revenue stream.

Net debt

The Province's investment in Muskrat Falls does not impact net debt. While the province may incur debt to finance a portion of the equity investment, it also has an offsetting asset to record- therefore there is no impact on net debt. The Muskrat Project assets are revenue generating assets. Excess revenues above the amount required to service the debt would be available to the Province.

Action being taken:

The Department of Finance will continue to evaluate the appropriate financing structure for its equity investment in the Project as the project moves toward final sanction and financial close in 2013.

Finance will continue its ongoing engagement with Nalcor in the finance raising process for the Nalcor project entity debt.

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