

Direction Note
Department of Natural Resources

Title: Accountability Oversight for the Muskrat Falls Project / Labrador-Island Transmission Link / Labrador Transmission Assets (collectively referred to as "the Project" in this note)

Decision / Direction Required:

Direction is required on Government's preferred approach to Project accountability, including public reporting and an independent process to review costs to determine the reasonability of costs incurred.

Background and Current Status:

- In April 2012, Cabinet directed the Departments of Natural Resources (NR), Justice and Finance, in consultation with Nalcor, to develop options for a Muskrat Falls Project accountability protocol that builds upon existing accountability mechanisms (including public reporting), which would include an independent process to review costs associated with the Project to determine the reasonability of costs incurred (MC2012-0240 refers).
- Nalcor is currently pursuing Project sanction and in order to minimize financing risk and secure favorable terms, Government intends to put legislative and regulatory measures in place that will assure sufficient revenue to the Project (from the Island interconnected ratepayers to Newfoundland and Labrador Hydro (NLH)) to pay Project debt financing and other costs. Part of this Government action will remove the Board of Commissioners of Public Utilities' (PUB) authority to review and approve costs of NLH related to the Project as part of the regulated electricity rate setting process. Effectively, the PUB will be directed to accept and incorporate the Project related costs into NLH's annual revenue requirements in setting Island interconnected rates. Consequently, the PUB would have no regulatory oversight over NLH as it relates to scrutiny of Project costs. The PUB will retain its authority to review and approve other NLH regulated costs, to allocate regulated costs charged to electricity customers and to set electricity rates.
- Mr. Robert Noseworthy, a former Chair of the PUB and an independent consultant engaged by NR, agrees that the Project cannot be regulated in the traditional regulatory sense by the PUB, but believes there has to be a significant and meaningful independent oversight over the costs related to the Project given the level of expenditures. Mr. Noseworthy further believes that since the ratepayer is required to cover all the costs incurred on the Project, it is incumbent on the Province to ensure that all costs are independently reviewed and released to the public in a report.

Accountability Oversight Options:

- There are two phases of Project expenditure under consideration for accountability oversight:
 - Project Development/Construction – Extends up to Project in-service currently anticipated in 2017/2018 and would include pre-development and development costs necessary to construct the Project facilities and bring them into service.
 - Project Operations – Begins with Project in-service and would extend over the operational life of the assets. This would include operation and maintenance (O&M) expenditures as well as capital refurbishment and replacement expenditures. A consideration for the operations phase is the extensive operating period of the asset (+50 years).
- There are a number of common issues for Government to consider irrespective of which option is selected. These include:
 - No Authority to Approve/Disapprove Expenditures – All oversight options are non-regulatory and provide for a review of expenditures incurred, after the fact, to determine the reasonability of same and provide a report to Government. They do not include any authority to approve or disapprove costs, including any questionable expenditure if encountered during the review. Given that the PUB will be directed to include all Project costs in rates, if any questionable expenditure is encountered, it would be a decision for Government at the time whether to reimburse ratepayers, either directly or indirectly through Nalcor, for any such expenditure.
 - Public Release – It is contemplated that periodic reports would be prepared for Government and subsequently released to the public. Government may wish to consider annual reports for the Project Operations phase and more frequent reports for the Project Development/Construction

- phase due to the high levels of expenditures during this phase.
- *Confidential Information* – In order for the oversight process to be credible, complete access to all of the Project expenditures will be required. This would likely include some information that Nalcor views as confidential or commercially sensitive and any public report would have to address Nalcor's concerns in this regard. The PUB Muskrat Falls review in 2011/2012 included submission of confidential information by Nalcor that was considered by Manitoba Hydro International and the PUB, although the information was not publicly released. The accountability oversight process may have to employ a similar approach.
 - *Pre-Sanction Expenditures* – Government may wish to consider whether the Project's pre-sanction expenditures are included under any such independent accountability oversight.
 - *Cost* - The cost of any such oversight would be small in comparison to the Project's cost. Who covers such cost (Government, Nalcor, ratepayers) may affect the process's perceived independence. Currently, the cost of PUB regulatory oversight of the NL electricity utility industry is charged to the utilities and recovered from the ratepayer through rates.

Project Development/Construction Phase:

- Expenditure oversight mechanisms that are or will be in place for this phase include:
 - Nalcor Internal Controls and Procedures – Nalcor (and subsidiaries) have internal structures in place including its Board of Directors, executive and officers with the responsibility to ensure appropriate corporate governance, decision making and accountability.
 - Independent Engineer - Nalcor, the lenders and the federal government will engage, at Nalcor's expense, an independent engineer to assess Project expenditures and approve the release of funds.
 - Nalcor's Annual Reports – Nalcor prepares a number of reports annually (eg. Annual Report, Strategic Plan) as required by legislation, which are released to the public.
- The independent engineer engaged by Nalcor is intended to provide Nalcor, the lenders and the federal government with an independent process to review costs associated with the Project to determine the reasonability of same and to subsequently approve the release of Project financing, both debt and equity components.
- Two approaches are put forth for consideration for this phase of the Project:
 - 1) **NL Utilizes the Same Independent Engineer as Nalcor / Federal Government**
 NL could utilize this same independent engineer to act as an advisor to Government and periodically provide a report to Government on the reasonability of costs incurred, with such reports to be released to the public. Nalcor is expected to engage this independent engineer at an early stage in the process.
 - Pros:
 - Provides an expert and independent perspective to Government.
 - Builds upon existing accountability mechanisms.
 - No duplication of effort.
 - Cons:
 - May not be perceived by the public and ratepayer as independent.
 - Mandate may have to be adjusted to meets Government's needs.
 - 2) **NL Utilizes a Different Independent Engineer than Nalcor / Federal Government**
 NL could engage a different engineering firm to act as an advisor to Government and report on the reasonability of costs incurred, with such reports to be released to the public.
 - Pros:
 - Provides an expert and independent perspective to Government.
 - May be perceived as more independent than using the same engineer as Nalcor.
 - NL could develop its own mandate and timing.
 - Cons:
 - Likely result in some duplication of effort.
 - Could result, at times, in a difference of opinion between the two engineers.

Project Operations Phase:

- Expenditure oversight mechanisms that are or will be in place for this phase include:
 - Nalcor Internal Controls and Procedures - (as described previously).
 - Nalcor's Annual Reports – (as described previously).
 Neither of these mechanisms is intended to provide Government with an independent process to review costs to determine the reasonability of costs incurred.
- Four options are put forth for consideration for this phase of the Project.

1) Independent Auditor

NL could engage a firm to act as an advisor directly to Government (independent of Nalcor, subsidiaries and partners) to carry out this oversight role and report on the reasonability of costs incurred.

Pros:

- Provides an expert and independent perspective to Government.

Cons:

- May be difficult to contract one firm for the entire operations phase (50+ years).
- Government may have to issue periodic RFPs (say every 5 years).
- Different firms would likely be engaged over time resulting in a loss of continuity.
- Raises the risk of no corporate oversight memory within the bureaucracy.

2) Board of Commissioners of Public Utilities (PUB)

Government could direct the PUB to carry out this oversight role and report on the reasonability of costs incurred. The PUB's role would be non-regulatory with no authority to act on its findings. *(This option has not been discussed with the PUB)*

Pros:

- PUB has experience in reviewing utilities' capital plans and rate applications.
- Independent of Nalcor and Government.
- PUB, or a successor, likely to exist for the entire operations phase (50+ years).

Cons:

- PUB review process could be time consuming.
- PUB may have to retain outside expertise - may be difficult to contract one firm for the entire operations phase.
- PUB normally holds public hearings as part of their review process and there may be public pressure for them to do likewise.
- PUB may be put in the difficult position of saying that some costs were not prudent, but at the same time being required to include them in rates.
- PUB may require additional financial and human resources.

3) NL Auditor General:

Government could direct the Auditor General (AG) to carry out this oversight role and report on the reasonability of costs incurred. *(This option has not been discussed with the AG)*

Pros:

- Independent of Nalcor and Government.
- May be perceived by the public and ratepayer as the most independent.
- AG's office likely to exist for the entire operations phase (50+ years).

Cons:

- AG may have to retain outside engineering/technical expertise - may be difficult to contract one firm for the entire operations phase.
- AG may require additional financial and human resources.

4) **Committee to Review Options and Make Recommendations.**

Mr. Robert Noseworthy believes this Phase is more challenging and suggests the appointment of a representative group to consider this matter and make recommendations on future on-going oversight for the project following commissioning. Mr. Noseworthy suggests such a group could consist of: (i) the current Consumer Advocate (representing the interests of consumers); (ii) the Auditor General (representing the interests of taxpayers); (iii) a former Chair/CEO of the PUB (representing the interests of ratepayers); and (iv) a representative of the Development/Construction Phase oversight group for purposes of continuity. Government could consider such a committee or another of similar structure, including a former Chair of a regulatory agency from outside the Province.

Pros:

- Committee's proposed composition is broad based.
- Committee's work may result in some unique and effective oversight options.

Cons:

- Public perception may be an issue if Government does not implement Committee's recommendation(s).
- Committee may need to consult with outside expertise to carry out their mandate.
- May be pressure for the committee to hold public meetings.
- Cost of committee would be an additional expense.

Recommendation:

It is recommended that:

- (i) For the Project Development/Construction Phase, Government utilize the same independent engineer as Nalcor to review Project expenditures and periodically [quarterly due to the level of expenditures] provide a report to Government on the reasonability of costs incurred, with such reports to be subsequently released to the public. This proposed approach would build on existing mechanisms and reduce duplication and cost. The Departments of Natural Resources, Finance [who leads] and Justice are directed to work with Nalcor to ensure the terms of reference for the independent engineer adequately reflect the needs of Government, including a review of any Project pre-sanction expenditures that are expected to be capitalized and eventually passed on to ratepayers. For purposes of independence, any incremental cost of engaging the independent engineer as a result of adjusting the terms of reference to meet Government's needs is to be born by Government
- (ii) For the Project Operations Phase, Government direct the Auditor General to carry out a periodic [annual] review of the Project's expenditures and report on the reasonability of costs incurred. The Departments of Natural Resources, Finance [who leads] and Justice are directed to work with Nalcor and the Auditor General to draft a terms of reference and develop the legislative amendments as required. For purposes of independence, all costs are to be born by Government.

Prepared By: NR, Justice

Approved By:

Ministerial Approval:

November 27, 2012

Oversight and Accountability for Muskrat Falls

- Cabinet Directed NR to look at models for oversight of MF in lieu excluding PUB
- NR engaged Bob Noseworthy, former DM and PUB Chair
- They looked at two oversight phases for the project:
 - During Construction
 - Post Construction (operations)
- For the period during construction, they examined 2 Options
 - Use the same Independent Engineer as the Lenders and Canada
 - Use a different Independent Engineer
- **The recommendation was to use the same IE as the Lenders and Canada**
- During the Post-construction (Operations) phase they examined 4 options
 - Independent Auditor
 - PUB
 - NL Auditor General
 - Defer to an Independent Committee to make a recommendation
 - Consumer Advocate; Auditor General; former Chair of PUB; representative from the Independent Engineer used during construction
- **The recommendation was to use the NL Auditor General**
- I disagree with the recommended approach as it would establish a situation where a biased AG would make and release reports about the project and the Nalcor without any input from Govt.
- I also disagree with the other approaches and have asked the team to re-visit. One option is to retain the IE from the Construction Phase.