

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:

Whether to consider means for independent oversight, scrutiny and accountability of Project cost expenditures.

Background and Current Status:

- Nalcor Energy is currently pursuing the Project development including negotiating agreements with Newfoundland and Labrador Hydro (NLH) and Emera as well as Project debt financing. In order to minimize debt financing risk, Government intends to put legislative and regulatory measures in place that will assure sufficient revenue to the Project (from the Island interconnected ratepayers to NLH and to back through to Nalcor/subsidiaries/partners) to pay Project debt financing and other costs in order to secure Project viability going forward.
- 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. The PUB will retain its authority to review and approve other NLH regulated costs, to allocate of regulated costs charged to electricity customers and to set electricity rates.
- Given the resulting lack of PUB oversight over NLH as relates to scrutiny of Project costs and no current PUB oversight over Nalcor Energy as an unregulated entity, Government would like to examine alternative and effective independent oversight, on behalf of the shareholder and ratepayer, of Nalcor Energy’s Project expenditures with the primary goal to provide a means to ensure accountability and prudent Project related spending.
- There are broadly two project aspects that would require consideration for expenditure oversight including:
 - Generation - Muskrat Falls Project (MFP)
 - Transmission - Labrador-Island Transmission Link (LIL) & Labrador Transmission Assets (LTA)
- There are essentially two phases of Project expenditure spending under consideration for accountability oversight including:
 - Project Development/Construction Phase – Extends up to Project in-service currently anticipated in 2017 and includes oversight of Project pre-development and development costs necessary to construct the Project facilities and bring into service. Accountability oversight could be conducted periodically during construction period.
 - Project Operations Phase – Begins with Project in-service and would extend over the operational life of the assets. These would include operation and maintenance (O&M) expenditures as well as capital refurbishment and replacement expenditures. This could also include oversight of Project decommissioning costs at the end of the useful life of the Project assets. A consideration for the operations phase is the extensive operating period of the asset (+50 years) and the most efficient approach for independent expenditure oversight.
- Other key considerations relating to Project expenditure oversight include:
 - [REDACTED]

- Government may want to consider remedy options if inappropriate/unnecessary expenditures are encountered through the audit review process. These could include allow cost overruns to flow through to ratepayers, Government would pay directly, Nalcor/shareholder could take lower return on equity or some combination of these options.
- The following are alternatives for the provision of additional oversight of expenditures related to the Project development/construction and operations phases. Government could utilize a combination of these options to provide oversight through both the construction and operations phases. For example, Government could utilize an independent engineer for the Project construction phase, engage the PUB or an auditor for the Project operations phase and augment these measures with detailed Project reporting by Nalcor Energy under its current annual corporate reporting requirements.

1) Independent Engineer

- NL would contractually engage a firm to act as an advisor directly to Government (independent of Nalcor, subsidiaries and partners) to review and report on Project cost estimates and expenditures. This would be similar to the engagement of Manitoba Hydro International to review cost estimates for Decision Gate 3 of the Project as well as similar to engagement of an independent engineer by Nalcor Energy through the Project construction phase as a requirement by debt financiers to ensure prudent Project spending.
- Pros:
 - Provide an expert and independent perspective to Government.
 - Could be utilized for both generation and transmission Project components.
 - Could be utilized through the construction and operations phases of the Project.
 - Could act as a regulator over Project managers and decisions.
 - [REDACTED] although may have to address access to commercially sensitive information.
 - Contemplated that reports would be publicly available.
- Cons:
 - May be difficult to contractually employ one firm for the entire operations phase of the Project given the extended operating life (50+ years) of the assets.
 - [REDACTED] Any remedies would likely be a decision of Government.
 - May be current legislative limitations on access to commercially sensitive and confidential information as well as restrictions public release.
 - Government to directly incur costs of independent engineer and its reviews.

2) Board of Commissioners of Public Utilities (PUB)

- Government would direct the PUB to review Project costs and provide a report to Government detailing the reasonableness of expenditures. [REDACTED]
- Pros:
 - PUB has experience in reviewing NLH and Newfoundland Power capital plans and electricity rate applications.
 - Could be utilized for both generation and transmission Project components.
 - Could be utilized through the construction and operations phases of the Project.
 - Independent of Nalcor Energy and Government.
 - Contemplated that PUB would issue periodic reports to Government.
 - Contemplated that reports would be publicly available although process would not

include public hearings.

- [REDACTED]
[REDACTED] Any remedies would likely be a decision of Government.
- Cons:
 - Nalcor Energy currently outside oversight of the PUB. May require legislative amendment.
 - [REDACTED]
 - Engagement process could be time consuming and add costs as PUB would likely also retain industry consultant expertise to help conduct its review.
 - Determine which entity (Government, Nalcor or ratepayer) would be responsible for paying the PUB's costs incurred for undertaking its review.
 - [REDACTED]
[REDACTED] Any remedies would likely be a decision of Government.
 - May be current limitations on access to commercially sensitive and confidential information as well as restrictions on any public release.

3) NL Auditor General or other Independent Auditor:

- Government would engage a financial auditor to review Project cost expenditures and report to Government on findings. Under Section 31(5) of the *Energy Corporations Act*, the "Lieutenant-Governor in Council may, by order, designate or appoint other auditors for carrying out the specific audit of the corporation's accounts and business that the Lieutenant-Governor in Council may specify in the order, and the auditor general may conduct the additional examination and investigation of the records and operations of the corporation that he or she considers necessary."
- Pros:
 - Independent of Nalcor Energy and Government.
 - Could be utilized for both generation and transmission Project components.
 - Could be utilized through the construction and operations phases of the Project.
 - Contemplated that reports would be publicly available.
- Cons:
 - May potentially lack engineering/technical expertise although could contract for any consultant expertise requirements.
 - The Auditor General reports to the NL House of Assembly. [REDACTED]
[REDACTED]
 - Determine which entity (Government, Nalcor or ratepayer) would be responsible for paying the auditor costs incurred for undertaking its review.
 - May be current limitations on access to commercially sensitive and confidential information as well as public release.
 - [REDACTED]
[REDACTED] Any remedies would likely be a decision of Government.

4) Nalcor Energy Annual Reporting

- Government to direct Nalcor Energy to include detailed reporting on Project cost expenditures as part of its Annual Report, Annual General Meeting, Strategic Plan and Annual Performance Report (presented to the House of Assembly under the *Transparency and Accountability Act* and reports on Nalcor's activities towards meeting goals and objectives of its Strategic Plan; also includes consolidated financial reporting).
- These reports are completed annually by Nalcor as required by current legislation, presented to Government and released to the public.
- Pros:

- These reports will continue annually through the Project construction and operation phases and could cover both Project generation and transmission aspects.
- Reports would be publicly available.
- o Cons:
 - As these reports are primarily at a consolidated corporate level, Government direction may be necessary to ensure that the scope and detail of reporting on the Project is adequate.
 - May be current limitations on access to commercially sensitive and confidential information as well as restrictions on any public release.
- Outside of the above oversight options and as the Project continues through the pre-development and development (construction) phases, a number of mechanisms and processes are or will be in place to facilitate Project decision-making and provide oversight on various expenditures. These include:
 - o Nalcor Internal Controls and Procedures - Nalcor (and subsidiaries) currently 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. These controls and procedures will continue through the Project operations phase.
 - o Decision Gate Process - Nalcor is employing a decision gate process to support various stages of Project decision-making. Currently, the process is approaching Decision Gate 3 (DG3) which will include a more advanced estimate of Project costs.
 - o Manitoba Hydro International (MHI) to Review DG3 project Cost Estimates - NL is engaging MHI to review Decision Gate 3 Project costs estimates and report to Government on its findings and recommendations.
 - o Federal Loan Guarantee Process - Federal government will undertake Project analysis and review as part of its assessment process prior to decision on the Project loan guarantee.
 - o Project Sanction - Project sanction decision to be considered by Nalcor's Board of Directors and Government which is expected to include finalized Project agreements as well as latest financing terms and Project costs estimates.
 - o Independent Engineer (Project Construction Phase) - During the construction phase in order to facilitate Project debt financing, Nalcor will engage an independent engineer to assess and report on Project expenditures.

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Ministerial Approval:

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