Date : 2/10/2009 5:32:13 PM
From : "Bown, Charles W."
To : "Dunderdale, Kathy"
Cc : "Thompson, Robert" , "Mullins, Kimberley"
Subject : Hydro Financial Viability
Attachment : ENERGY POLICY - ELECTRICITY & ENERGY EFFICIENCY - UTILITIES - NEWFOUNDLAND & LABRADOR ~ Memorandum on Financial Viability.DOC;Hydro Paper - Speaking Points.doc;Hydro Paper - LARGE Speaking Points.doc;

Minister;

As promised, I have enclosed a briefing note that summarizes the Paper and I have provided some suggested speaking ponits for tomorrow. I have also enclosed a file with the speaking notes in a large font. Derrick Sturge will be giving the presentation tomorrow for NALCOR which I will forward to you under separate cover. If you have questions in the morning, I will be at the East Block at 8:30 for a pre-meeting with Derrick.

Charles

Briefing Note
Department of Natural Resources

Title: Financial Viability of Newfoundland and Labrador Hydro (NLH)

Issue: Memorandum to Executive Council

Background:

- The Memorandum makes a case for directing PUB to allow NLH to make an improved rate of return on equity (RoE), to earn a return on equity on assets used in rural operations, and to be allowed to improve its debt: equity ratio so as to be able to earn that return on a higher equity portion of its total capital.

- The Memorandum also recommends that the equity infusion of $100 million approved in Budget 2008-09 for NLH be implemented.

- Three important factors that have resulted in Hydro's poor financial condition as a regulated utility are:
  (i) The low target RoE ordered by PUB;
  (ii) The denial by PUB of a return on assets employed to serve NLH's rural customers; and
  (iii) NLH's high debt to equity ratio resulting from previous dividend requests by Government and the low average net income resulting from the combination of (i) and (ii).

- The case for action is based on four primary factors:

  1. It is planned that NLH will purchase approximately one-third of the firm output of Gull Island for resale to customers within the province, and therefore NLH needs to demonstrate to the financial community that it is a creditworthy customer for a power purchase agreement without relying on extension of Government's loan guarantee. NLH believes this necessitates it being in a position to achieve significantly greater net income than is currently the case;
  2. NLH believes that its low net income level also jeopardizes its creditworthiness by increasing the risk it faces that income could be reduced by extraordinary expenditures (e.g. emergency repairs) that it cannot recover through the rate process, and that a more robust income would provide a greater cushion against such eventualities;
  3. An improved net income would also allow NLH to finance its ongoing and new business ventures, and assist NALCOR in obtaining financing for its activities other than Lower Churchill itself, including the transmission interconnection between Labrador and the Island, large-scale wind projects and oil and gas projects; and
  4. As the measures result over time in a significant improvement in the financial health of NLH, it would be able to provide a dividend flow to NALCOR to reduce

the amount of future equity investments which that company would otherwise need from Government.

- The measures recommended by NLH would result in an incremental $20 million to NLH's net income. This would increase NLH's rates by approximately 4%. As mitigation, NLH recommends Government permanently forego the 1% fee charged for Government's guarantee of outstanding debts. This is currently in the order of $12 million. This action would reduce the rate impact to 1%.

Analysis:

- For Treasury Board, the main item is likely to be the permanent waiver of the debt guarantee fee. Government would still be providing the guarantee, but with no fee. Normal PUB procedure would be that with NLH's next General Rate Application, anticipated in 2009 for 2010 rates, this benefit of lower overall borrowing costs would be passed on to customers.

- The Debt Guarantee allows NLH to borrow at the same rate of interest as Government. In developing the Memorandum, NLH and Department of Finance differed over the value of the guarantee to NLH and its customers. NLH considers 1% to be the maximum, whereas Finance appeared to be of the opinion that it could be worth significantly more.

- Department of Finance may not be supportive of the permanent waiver of the Guarantee Fee. It has indicated that Government does guarantee the debt of other Crown Corporations, such as Newfoundland and Labrador Municipal Financing Corporation, but this Corporation is financially dependent on Government for the funds to repay its debt through budgetary allocations to DMA. No guarantee fee is charged because the fee would have to be covered through an additional budgetary allocation by the Province and the transaction would effectively net out to nil.

- Department of Finance points out that Hydro is a commercial enterprise and is financially self-supporting, it receives a significant benefit from the guarantee in excess of its cost and it has the ability to pass along the cost of the guarantee to ratepayers. The Department suggests the situation is more comparable to the Provincial guarantee of other commercial enterprises where a guarantee fee of between 1 and 2% is charged.

- NLH has not suggested any other immediate measures to mitigate the rate impact of the measures to increase NLH's net income.

- The Memorandum indicates that, on a consolidated basis, the Province would be better off by $3 million annually. This $3 million would come from provincial ratepayers.

- The Memorandum provides two alternatives. The recommended alternative is to issue Orders in Council that:

  a) Direct the Board of Commissioners of Public Utilities under Section 5.1 of the *Electrical Power Control Act 1994* to adopt the following policies for Newfoundland and Labrador Hydro's next General Rate Application:
  - In calculating the revenue requirement of NLH, to allow the same Return on Equity as approved from time to time after tax for Newfoundland Power;
  - To allow Newfoundland and Labrador Hydro to earn the approved rate of return on all its rural assets; and
  - To allow Newfoundland and Labrador Hydro's capital structure to have a proportion of equity up to that allowed for NP;

  b) Permanently waive Newfoundland and Labrador Hydro's annual debt guarantee fee; and

  c) Approve the release to Newfoundland and Labrador Hydro of the $100 million equity investment approved in the 2008/09 Provincial Budget.

- The other alternative, which is not recommended, is to take no action. NLH will make application to PUB for rate changes based on the proposed solutions, but without the certainty of outcome that would result from Government direction to PUB.

Current Status:

- The Memorandum has been signed and submitted, and will be on the Treasury Board agenda in the near future.

Prepared by: David Bazeley, Electricity & Energy Efficiency
Approved by: Charles W. Bown

Ministerial Approval:

January 23, 2009