From: Brewer, Donna
To: Marshall Q.C., Hon. Thomas
Cc: Myrden, Paul; Au, Peter
Subject: FW: LC - ESA and ESG - Cost Overrun Provisions
Date: Friday, November 8, 2013 5:21:35 PM
Attachments: 2013-11-04 draft email on cost overruns.docx

Minister
NR and Nalcor are working on the issue raised by Todd below.

When you are back in town, Paul and I can brief you on this matter. I expect it will be raised at EPC as well.

Until Paul and I see the wording (being looked at over the weekend), it is difficult to assess the financial impact.
Our current thinking - At Financial Close, a revised project cost estimate will be provided (by the Independent Engineer) and that will form the new project baseline (not the DG3 numbers). From that time forward, any changes resulting in higher project costs, the Province / Nalcor will have to fund the difference by placing funds in what we believe may be some sort of escrow account. Paul thinks if it is a budget appropriation issue for us it may arise beginning in 2014/15 vs. 2013/14.

Sincerely,

Donna Brewer, CA
Deputy Minister
Department of Finance

From: Stanley, Todd
Sent: Thursday, November 07, 2013 2:14 PM
To: Bown, Charles W.; Brewer, Donna; Myrden, Paul; Morris, Paul J.
Cc: Pelletier, Randy; Bertoldi, Linda; Fowler, Bruce
Subject: LC - ESA and ESG - Cost Overrun Provisions
Importance: High

I need instructions on a $$$ business issue that requires someone contact Nalcor about work they are doing (I think).

The FLG has language in it essentially requiring a continuing accounting for and funding of cost overruns. Canada has apparently been struggling with how to deal with this language which is problematic but from which they feel they have no authority to deviate. They have recommended the attached description of how cost overruns would be handled.

This proposal would apparently change equity funding numbers as it would require additional equity be committed to a fund to cover cost overruns from the beginning of the Project, but with those funds only being expended or returned if not necessary at the end. Nalcor is apparently analyzing the impact of this change now.

From a legal standpoint the drafting changes to the ESG and ESA are likely going to be nominal. The larger issue is whether the approach makes a $$$ issue / concern for the Province. As such I think someone from Finance needs to advise? A revised ESG draft with this concept included is expected soon.

Todd Stanley
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We have spent a very great deal of time and effort reviewing the mix of the specific terms of the Term Sheet at s. 4.10; your comments and concerns around the NL Equity assurances and the need for a clause; the negotiations and purpose of the term including the evolution of the drafting and the Cabinet mandate that directed the Term Sheet. We have determined that we do have to include a term addressing the requirements of s. 4.10 when we balance out these considerations and require it to be a covenant of each of the credit agreements. Let me know if you want to draft from this explanation or want us to do so.
The elements that we have to have to cover off to satisfy Term Sheet s. 4.10 are a) Cost Overruns defined properly b) "funded" defined c) payment obligations that include the annual funding option d) IE confirmation including as to adjustments e) respect s. 3.1 debt to equity, caps etc. and 4.8 Additional Debt restrictions f) IE certificate re Expected Costs to Complete.

1. The calculation of the Cost Overruns starts at Financial Close and is determined at any time there is a draw request or a change approval. In both cases of a draw or a change order approval a progress certificate is required (the draw and change certificate s will include all of the elements of s. 4.10 and more; which is to be reviewed and confirmed or commented on by the IE). This certificate will include a costs to date and a cost to complete calculation, this is standard for project finance during construction. The first of such packages will be delivered at Financial close to set a base line.

2. We need a definition of Cost Overruns to flesh out the definitions of s. 4.8 a) I suggest calculated at the relevant point in time –
   The concept should be - a) the remaining costs on the committed contracts b) plus the budget amount for the non-contracted items including related contingency and escalation c) plus contingency exposure and escalation as contracted in committed contracts (if any) d) less saving available under contracts reasonably achievable (IE determines) e) plus finance costs due at COD **LESS** the aggregate of a) budget amount less amounts paid to date b) Additional Debt then available to finance by the tests c) Guaranteed Debt remaining d) Equity on the debt to equity ratio to match the Guaranteed Debt not yet advanced gives Cost Overrun for purpose of funding. What this is doing is pinning down what the cost increases are in a reasonable manner and then backing out the prior allowed financing and required equity which leaves the additional equity component.

   The concept and mandate being (for this section and this fits with s. 4.8) all amounts over the firmed up budget amount and the prior sources of amount funded by the debt, equity on the usual advance for debt to equity and additional debt [it] to be funded by equity. The assessment of each amount is part of the draw or change approval engineer certificates in the ordinary course. This limits Cost to actual and firmly identified cost, which is intended to deal with the current project status as not fully contracted and provide allowances for savings.

   This translates to a formula approach as follows:
   "costs" means
   (a) remaining costs (payment obligations) on committed contracts; plus
   (b) budget amount for non-contracted items including related contingency and escalation; plus
   (c) contingency exposure and escalation as contracted in committed contracts (if any)
   LESS

(d) savings available under executed contracts reasonably achievable (IE determines);
(e) contingencies under completed contracts;
(f) allowance for cost savings reasonably achievable in yet to be contracted items as certified by the IE

PLUS

(g) finance costs due and payable up to COD.

Then Cost Overrun which is defined as cost increase in s. 4.8 should be defined as the following to take into account all of the terms of s. 4.10:

“cost increase” or “Cost Overrun” means costs less

(i) the aggregate of the budget amounts less amounts paid to date against budget;
(ii) Guaranteed Debt not yet advanced;
(iii) equity required by the usual course payments needed to meet the debt to equity requirements for the Guaranteed Debt not yet advanced;

This takes the costs then remaining with the estimates of higher costs included and takes off the related remaining budget (because you cannot have an increase until you exceed aggregate budget) and the otherwise committed sources that precede a need for further equity funding.

3. Then we need to define “funded” in a manner that is reasonably efficient but meets the needs of s. 4.10. This requires an actual flow of funds with respect to cost overruns on the time table that is set out in the term sheet (which was a heavily negotiated term). To make this fit in the context of the transaction as it has evolved Canada can accept that funds i.e. cash (if and when required by the cost overrun provisions) can go, at your option, either to the Project or to an escrow account for later application. Canada will also permit annual adjustment of the escrow amount required against subsequent assessments of the cost overrun based on the formulas above and in the term sheet. In the event that funds are put into escrow, the project will continue to first be funded by baseline equity and guaranteed debt, and the balance of the escrow account would not factor into the pro rata contributions of the guaranteed debt and baseline equity to meet the debt-equity ratio requirements of the term sheet. Once guaranteed debt and baseline equity are exhausted, then the contingent cash set aside in the escrow account would fund the remaining project costs, however should such cash not be sufficient, Nalcor will be responsible for further funding either with additional contingent equity or additional debt that is borrowed subject to the restrictions in the term sheet.

   The escrow account will be under the control of the Collateral Agent for the purpose of funding cost overruns but subject to return on adjustment or no requirement as that emerges. The funds in the account will be part of Canada’s security package.

   This is a form of funding meeting the requirements of s. 4.10 but allowing for actual advance to the project only when actually needed, which allows adjustments as reductions are identified and therefore the funds are held against “real” need as opposed to speculation and potential reversing using debt if savings are found.