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Attachments: [OCOR-23982 Discussion Questions - Enhanced Federal Loan Guarantee.DOC](#)

Responses to federal questions.

Charles

CONFIDENTIAL DRAFT**Discussion Questions**

- 1. How would NL finance the cost of overruns if an additional loan guarantee was not provided? Would NL consider lending money (either directly or via Nalcor) to the project entities, or providing a provincial loan guarantee?***

The Province of Newfoundland and Labrador is seeking an enhanced Federal Loan Guarantee for the Muskrat Falls Project as part of its actions in addressing NL's current fiscal challenges. An enhanced Loan Guarantee would:

- a. Allow NL and the Muskrat Falls Project to leverage the Federal Government's AAA credit rating, resulting in lower financing costs for the capital necessary to complete the project. In the absence of such an enhanced guarantee, the Province would have to fund the capital through its provincial borrowing program at higher rates. This would result in higher overall financing costs for the Province which will further deteriorate the current fiscal situation and require further cost savings actions by the Province to address the differential.
- b. Provide greater liquidity for the Province. In the absence of such a guarantee, the Province will have to borrow capital necessary to complete the Project, further reducing the Province's liquidity and borrowing capacity. Such constraints may result in further deterioration of the Province's credit rating and even higher financing costs for any additional Provincial borrowings or renewals.

If a loan guarantee was not provided, the Province would finance the cost of overruns by borrowing to provide Nalcor with additional funding to complete the Project. The potential negative impacts of such action on NL's fiscal situation are outlined above. The Province could consider lending the money to Nalcor if it is determined that providing such a loan would have advantages over providing such funding through an equity injection. In either circumstance, the Province would have to borrow the funds in the capital markets which would increase our gross debt and increase interest payments further impacting the Province's fiscal situation and recovery.

The Province would likely not provide a provincial loan guarantee. It is anticipated that even with a provincial loan guarantee, Nalcor's cost of borrowing such funds in the capital markets would be higher than the financing costs incurred if the Province borrowed the funds directly. This would result in higher interest costs which would reduce Nalcor's consolidated net income and the Province's dividends available from the Project, further impacting the Province's fiscal situation and recovery. Also, it is likely that some of the credit rating agencies would view a loan guarantee by the Province the same as a direct borrowing by the Province in its analysis, providing no credit advantage.

CONFIDENTIAL DRAFT**2. *What is NL's estimate of the retail price savings from a federal loan guarantee, and on what assumptions is this figure based?***

The primary benefit of the enhanced Federal Loan Guarantee is to reduce the future borrowing requirements of the province. An important ancillary benefit is a reduction in cost to the island electricity rate payers. Based on an assumed interest rate of 3.8% as presented to representatives of the Government of Canada in June 2016, the replacement of equity with federally guaranteed debt within the project financing structure results in an estimated reduction of retail rates for the average island interconnected customer in the range of 1 to 1.5 cents per kilowatt hour. The major assumptions that underpin this analysis include the following:

- a) Facilities capital costs of \$9.1 billion as per the June 2016 update.
- b) Estimated commissioning date of June 1, 2020.
- c) Financial parameters similar to those under the original Federal Loan Guarantee and Project Finance Agreement:
 - a. Max Debt Equity Ratio for MF/LTA and LIL of 65:35 and 75:25 respectively;
 - b. Minimum Debt Service Coverage Ratio of 1.4 times; and,
 - c. Provision for Debt Service Reserve Account and Liquidity Reserve Accounts on same basis as the original Federal Loan Guarantee.
- d) New debt under enhanced Federal Loan Guarantee of \$2.9 billion issued at 3.8% with financial close in November 2016.
- e) New debt would be amortized in the same fashion as existing debt with MF/LTA and LIL amortized over 30 years and 35 years respectively, with bullet refinancing at the end of the term for LIL.
- f) First installment of sinking fund payments moved from December 1, 2018 to six month post commissioning.
- g) The COREA concept is eliminated and effective November 2016, any current balance will be used as eligible equity in accordance with the monthly funding provisions from the financing agreements that will remain in place.

3. *I understand the portion of the Base Block that is not required on the Island is to be exported, and the resulting revenues used to mitigate electricity prices for NL consumers. Does NL intend to do the same with revenues from the Supplemental Block (which is the electricity produced by Muskrat Falls that is in excess of the Base Block and the Nova Scotia Block)?*

Yes. In the December 14 mandate letter from our Premier to the Minister of Natural Resources, Minister Coady was asked to “direct Nalcor to sell surplus power generated from the Muskrat Falls Project and use revenue to mitigate potential increases in electricity rates and ratepayers' bills.” From an economic policy perspective, it is critical that NL electricity rates are competitive.

CONFIDENTIAL DRAFT**4. *What other mitigation measures are you considering? Are you considering using equity returns to subsidize electricity rates?***

The Government of NL has committed to using the sale of excess power to mitigate electricity rates to the ratepayers. We have also instructed the Nalcor CEO to consider all opportunities to further mitigate rates. As part of this, the Government of NL is considering using equity returns to mitigate rates. There are other policy options which could be considered, including a full or partial point-of-sale rebate of the HST on electricity bills.

It is important to note that these equity returns represent a significant revenue stream for the Province and are already factored into the Province's seven year return to surplus plan as outlined in Budget 2016. Any redirection of these returns to rate mitigation will result in a reduction in the revenue stream available to the Province, or alternatively introduce a new expenditure for the Province if mitigation is delivered directly by Government through some other policy means such as an energy rebate program.

The Government continues to monitor the project and electricity rates for neighbouring jurisdictions. Given it is four (4) years before any rate increases are realized from the delivery of power from the Muskrat Falls Project, it is premature for the Government to make any firm policy commitment on the extent and form of rate mitigation to be delivered.

It is important to recognize that any mitigation will further deteriorate the Province's fiscal forecast requiring the province to identify further expense reductions and puts the province's commitment to return to surplus by 2022/23 at extreme risk. Credit rating agencies and potential investors view the possibility of the province accumulating more debt beyond the levels outlined in its Budget 2016 seven-year plan as a negative credit risk which will lead to even higher and more volatile credit spreads for the province and by extension Nalcor / NL Hydro.

5. *There has been some talk of the potential for improved relations between Newfoundland and Quebec; in particular, I understand there is a tentative Memorandum of Understanding related to the Agreement on Internal Trade. The CEO of Nalcor has also talked about exploring opportunities to supply Muskrat Falls power to Quebec. Could you provide some details on these discussions? What is the scope of NL and Nalcor's engagement with Quebec and Hydro-Quebec?*

We have not entered into or negotiated any Memorandum of Understanding with Quebec related to the Agreement on Internal Trade or energy matters in general. There were discussions at the AIT table to set out open access rules for electricity in the Canada Free Trade Agreement and that process is currently ongoing. Quebec did express an interest to have further discussions with NL over electricity development and trade once these rules are resolved. However, we continue to explore opportunities with multiple customers to enhance the value of our surplus energy. Nalcor officials have held preliminary discussions with Hydro-Quebec to begin establishing a relationship that will help us

CONFIDENTIAL DRAFT

determine whether any opportunities exist to advance our interests. It is important that we have working relationships with all our neighboring jurisdictions if we are serious about maximizing the value of our energy exports and maximizing our contribution towards meeting Canada's emissions reduction targets.

6. *What is the province's plan for funding additional cost overruns beyond the current cost to complete, should they occur?*

The Province's plan for funding any additional cost overruns is through equity injections. Any such further overruns, if realized, would further increase the Province's forecasted borrowing requirements which would increase our gross debt and interest payments, further impacting the Province's fiscal situation and recovery.

7. *The Nunatsiavut Government has been demanding that NL require Nalcor to fully clear the reservoir of timber, brush and topsoil to limit the production of methylmercury. I understand that undertaking such a reservoir clearing regime would be costly and also would have further impacts on the project schedule. From Canada's standpoint, this is a matter of provincial jurisdiction. That said, given Canada's interest in the projects, how do you perceive the legal risk of proceeding with the current plan of partial clearing?*

The reservoir clearing plan adopted for Muskrat Falls is consistent with the proponent's "partial clearing" plan (approximately 75% of timber) described in the environmental assessment for the project. The JRP recommended that Nalcor's "full clearing" (not 100% due to accessibility/safety limitations associated with slope and terrain) plan be applied, which the provincial government did not endorse at the time given the limited opportunity to market the harvested timber. We can find no record of the Nunatsiavut Government proposing soil removal during the environmental assessment for the Lower Churchill Hydroelectric Generation Project, albeit there was some discussion regarding soil removal in the JRP report that led to a recommendation by the panel (recommendation 6.5) for a pilot study, to undertaken outside the Churchill River. That recommendation was posed to the Federal Government to which they responded.

Consequently, soil clearing for the Muskrat Falls project was not approved by either Canada or Newfoundland and Labrador through either environmental assessment or subsequent permitting.

Soil stripping is therefore not a part of the current project. Given the potential for impacts on fish and fish habitat from further clearing and soil stripping, Nalcor is of the view that a federal EA trigger exists related to these impacts and a subsequent section 35 Fisheries Act authorization. Nalcor also notes that

CONFIDENTIAL DRAFT

any new reservoir clearing/stripping undertaking may trigger federal EA provisions through the operation of the federal loan guarantee. Provincial triggers would also apply.

In 2014, the Nunatsiavut Government (NG) brought a Court action to quash the provincial Minister's decision to grant Nalcor a permit to alter a body of water. The issue of clearing of the reservoir was raised in the proceedings. The Court determined that the appropriate time for the NG to challenge the Province's decision not to compel full clearing was when the Province issued its responses to the JRP recommendations. The Court found that "the province's response settled and decided the matter. Nothing further was required." The Court also noted that the law does not contemplate "that decisions may effectively remain open for challenge long after they have been taken and the development has moved forward on the basis of such decisions".