[redacted] [redacted]

Attach to: **NR2012-[redacted]**
EPC2012-

[redacted]

Title **<u>Funding of the Churchill Falls Hydro Electric Development Redress Agreement</u>**

Summary of Proposal

The Submission seeks Cabinet approval that:

1) Government assume Nalcor's financial responsibility for the Settlement Payment to the Innu Nation under Clause 2.1 outlined in the Upper Churchill Redress Agreement which equates to $2 million per annum (beginning in 2011), escalating at a rate of 2.5 percent per annum until 2041;

2) The Department of Finance be directed to assess and record the precise net present value of the financial obligation in accordance with standard procedures, and;

3) The fiscal framework be adjusted to accommodate for the Settlement Payment over the life of the Upper Churchill Redress Agreement.

Secretariat Comment

1. The 2008 New Dawn Agreement between the Province, the Innu Nation and the Energy Corporation of NL (now Nalcor) provided a framework for the negotiation of the Churchill Falls Hydroelectric Development Redress Agreement (Redress Agreement), the Lower Churchill Innu Impacts and Benefits Agreement (IBA) and the bilateral Land Claim Agreement-in-Principle (AIP).

2. The object of the Redress Agreement is to compensate the Labrador Innu for historical inequities in relation to the Upper Churchill project [redacted]

3. [redacted] Nalcor has estimated the present value of these payments to be approximately $40 million, while the Department of Finance estimates the present value of the payments to be $46.5 million, $90.6 million in terms of cash requirements over the 30 year at period.

4. The Department of Natural Resources (NR) indicates that the execution of the Redress Agreement triggered an immediate payment to the Innu Nation of $2 million. TBM2011[redacted] authorized NR to transfer $2 million in funds internally to make this payment, though did not explicitly direct the funds to be transferred to Nalcor or that the payment be made on behalf of Nalcor. TBM2011-[redacted] also directed NR to return to Cabinet for direction on responsibility for future payment over the life of the Redress Agreement to 2041.

5. Nalcor has indicated that their financial position will be adversely affected if they are required to continue to assume financial responsibility for the Settlement Payment, whereas accounting for the Settlement Payment directly by the Province has a virtually neutral impact on the Province. This is because the Province's 100% ownership of Nalcor's shares means it must account for the obligation on its own books regardless of whether Nalcor continues to have financial responsibility for the payment.

6. Cabinet Secretariat notes the following:

- The Submission states at the top of page 4 that "Should the Province directly assume the financial responsibility, [for the Settlement Payment] Nalcor would not record any expense related to the Redress Agreement, thereby preserving recent improvements in its net income levels and implicitly validating its business strategy." [redacted] Whether provincial assumption of financial responsibility for the Settlement Payment as reflected in an MC, for example, would enable Nalcor to exclude the Settlement Payment as an obligation in its financials is an accounting question that requires further analysis. It should be noted that on page 3 of Annex "B", the Department of Finance BN, it is stated that [redacted]

- The Finance BN attached as Annex "B" seems to suggest the Redress Agreement contains other financial obligations for Nalcor (a copy of the Redress Agreement is not attached to the Submission). The excerpt from page 4 of the Submission quoted in the previous paragraph, however, does not seem to take account of this when it states that if NL took on the Settlement Payment "Nalcor would not record any expense related to the Redress Agreement".

- Recommendation #1 seeks approval for NL to assume Nalcor's responsibility for the payment "beginning in 2011." NR has indicated, however, that the payment has already been made for fiscal year 2011-12, so would seem to be required is approval for NL to assume financial responsibility for the payment

already paid

beginning in fiscal year 2012/13 and thereafter.

- [redacted]

- While a copy of the Redress Agreement is not attached to the Submission, Clause 2(a) of the New Dawn Agreement says the payment shall be made commencing on execution of the IBA, not the Redress Agreement. any problem?

- In TB-ME-2011-[redacted] (which is not attached to the Submission) NR requested reallocation of $2 million "for the Department to provide funding to Nalcor Energy in order to enable Nalcor Energy to issue "Settlement Payment" to the Innu Nation as negotiated under the Redress Agreement (Redress Agreement)." It is observed that TBM2011-[redacted], which is attached as Annex "A", authorizes transfer of the $2 million within NR but does not explicitly direct the funds to be transferred to Nalcor.

Budget Division Consultation Budget Division of the Department of Finance had no issue with the Submission from a financial perspective.

Secretariat Recommendation

CQ/DH
February 21, 2012

ANNEX B

BRIEFING NOTE

ACCOUNTING TREATMENT OF PAYMENT TO BE MADE TO THE INNU OF LABRADOR AS PER THE CHURCHILL FALLS HYDRO-ELECTRIC DEVELOPMENT REDRESS AGREEMENT

PURPOSE

The purpose of this briefing note is to provide guidance to the Department of Natural Resources on the following:

- Pursuant to the departmental proposal letter TB-ME-2011-[redacted]and TBM2011-[redacted], to determine the appropriate accounting treatment for the $2.0 million transfer of funds as requested by the Department of Natural Resources ("the Department") and to advise if the transfer of funds has to be adjusted.
- Pursuant to the e-mail from the Departmental Controller dated October 14, 2011 and the documents mentioned above, to advise the Department on the accounting treatment for the "Settlement Payment" under the *Churchill Falls Hydro-Electric Development Redress Agreement* ("*Redress Agreement*") if the amounts were recorded in the Consolidated Revenue Fund (CRF) of the Government of Newfoundland and Labrador ("the Province") as per Public Sector Accounting (PSA) Standards.
- To clarify, for information purposes, the impact on the Consolidated Summary Financial Statements (CSFS) of the Province regardless of which party is responsible and ultimately records the long term liability associated with the Settlement Payments.
- To illustrate the journal entries required to record the impact of the payment at inception and over the life of the agreement.

BACKGROUND

- The following are the contracted parties and have agreed to these payments as per the *Redress Agreement*:
    - Nalcor Energy ("Nalcor")
    - Innu Nation
    - Mushuau Innu First Nation
    - Sheshatshiu Innu First Nation
    - Province of Newfoundland and Labrador
- As per the *Redress Agreement,* section 2.1, :" *Subject to Clauses 2.2 and 2.3, for each year, or prorated for part years, following the Effective Date, Nalcor Energy shall*

pay to Innu Nation an annual payment of two million dollars ($2,000,000.00) (herein referred to as the Settlement Payment), which in either case shall:

(a) be paid annually commencing on the Effective Date;
(b) be increased annually on each anniversary of the Effective Date at the rate of two and one-half percent (2.5%);
(c) terminate on August 31, 2041; and
(d) be prorated for the part year between the date of the final Settlement Payment and August 31, 2041...."

- [redacted]
- [redacted]

ANALYSIS

- This section gives consideration to the:
  1. accounting treatment of the $2.0 million transfer of funds as noted in section 2 of TBM2011-[redacted] without any potential adjustments related to other clauses that may impact the net payout of the amount;
  2. accounting treatment of future Settlement Payments if the responsibility for those payments was transferred to the Province and recognized as a liability and expense in the CRF. The analysis will include a review of the measurement of the liability without any potential adjustments related to other clauses that may impact the net payout of the amount, and;
  3. potential impacts on the CRF and the CSFS of the Province
- The briefing note will also address the comment by Nalcor officials, as detailed in the proposal letter, on the potential of capitalizing the Settlement Payment within the total cost of the Muskrat Falls development project.
- To clarify the distinction between the CRF and the CSFS,
  - o the CRF includes all departments, and
  - o The CSFS includes all departments and government organizations controlled and thereby accountable to government.
- For further details on the accounting standards addressed in the analysis, Schedule I provides the relevant excerpts from the PSA Standards.

1. <u>Treatment of the Payment to Nalcor as a Grant</u>

- PS 3410 provides guidance as to government transfers (grants). In summary from PS 3410, grants can be considered the fund transfers of a government that are discretionary, subjected to limits on the amounts, timing and eligibility and must have legislative approval.

- Per TBM2011-[redacted] and proposal TB-ME-2011-[redacted], the Province has decided to distribute funds from the Department to Nalcor for the payment of the first Settlement Payment to the Innu of Labrador.
- To account for the "funding" of Settlement Payment as a grant expense would be considered appropriate in this situation as the funds distribution would meet the accounting standards criteria of a grant. Also, there is no indication in the TBM that the payment is intended to be an investment in the company or a payment to satisfy a formal liability to the company which would result in a differing accounting treatment. As an annual grant, an annual budget appropriation will also have to be requested by the Department for the life of the agreement.
- The impacts on the Public Accounts of the Province will be as follows. Within the CRF, a grant expense would be recorded on an annual basis, reducing the annual surplus or increasing the annual deficit. In the CSFS, when including the financial statements of Nalcor, the impact to the annual surplus/deficit will be nil as the entry to record the grant in Nalcor will offset the entry to the CRF
- Refer to Appendix I for an illustration of the necessary journal entries to record in the CRF. In treating the payment to Nalcor as a grant, it is assumed the liability for and expense of the annual Settlement Payment to the Innu is recorded by Nalcor. A review of the impacts of the liability and related expense is included in the section below.

2. Recording the Liability in the Public Accounts of the Province

- As per PS 3200, a present obligation to others that arises from a past transaction or event where the settlement would result in the future sacrifice of economic benefits would be considered a liability.
- In relation to the Settlement Payment, the characteristics of a liability were met when the obligating event, the official signing of the Redress Agreement, occurred on November 18, 2011 committing Nalcor to the future payments and giving it little discretion to avoid settlement of the obligation based on the terms of the agreement and the specified repayment details. As a result, the amount of the liability and expense would be recorded by Nalcor in the period ending after November 18, 2011.
- [redacted]
- If the obligation for the Settlement Payment is transferred to the Province, then the amounts of the liability and expense would be recorded in the CRF, through

the Department, and ultimately in the CSFS of the Province. The liability and expense amounts for the Province are detailed in Appendices II and III.

- For the CSFS for the period ended March 31, 2011, the Province will have a subsequent event note to disclose relating to the signing of the agreement on November 18, 2011.

Measurement of the Liability if Recorded in the CRF

- The Redress Agreement specifies that the payments are to be made over a 30 year timeframe. Over this period, the cash outlays would be approximately $90.6 million (Refer to Appendix II).
- To reflect the substance of the obligation, it must be discounted over the life of the agreement. The net present value (NPV) of the payments must be recognized as long term debt (liability), with the associated interest/discount expense being recognized along with the principal amount each year. See Appendix II for the calculation of the NPV and the interest/discount expense and Appendix III for an illustration of the journal entries that are required in the first three years.
- Using a discount rate of 4.54%, which is the Provinces cost of borrowing for a period of 30 years (effective March 31, 2011), the NPV of payments is estimated to be $46.5 million with an interest/discount expense of approximately $44.1 million over the life of the agreement. These amounts can be affected by the timing of the payments and the discount rate used.
- The amount of the liability and expense for Nalcor would be different than that of the Province due to the differences in the cost of borrowing (discount rate).

3. Accounting Impacts of Recording a Liability on the CRF and the Consolidated Summary Financial Statement

- If the liability were recorded by the Department, there would be an increase in the expense and liability accounts of the CRF and would flow directly through to the CSFS as such.
- No such impact would occur on the CRF if liability and expense were recorded by Nalcor. In the Nalcor financial statements, the accounting impacts would be similar to those of the CRF above, an increase in liability and an increase in expense, however in the CSFS upon consolidation of the Nalcor financial statements, the net impact to the annual surplus/deficit will be the same as if the amounts were recorded in the CRF.
- The impact to the CSFS annual surplus/deficit in the year ended March 31, 2012 will be the same regardless of whether the expense is recorded in the Department or in Nalcor. The presentation of the liability on the Statement of Financial Position within the CSFS will be as an increase in the Other Liabilities, if recorded in the CRF, or as a decrease in the Investment in Nalcor, if recorded by Nalcor. Therefore, no difference in the impact to Net Debt.

4. Capitalization of the Payments

   As the payments under the Redress Agreement are for the settlement of the outstanding grievance of the Innu Nation with regard to damages suffered to Innu lands and properties as a result of the flooding caused by the upper Churchill River development in the 1960s, there is a very strong argument against any connection to the potential development of the Muskrat Falls Hydro project. Therefore, no justification would exist to capitalize the payments as a part of the Project costs within Nalcor. This appears to be in contrast to the position put forward by Nalcor's auditors that there is the potential that the Settlement Payments could be considered capital costs of the project (refer to proposal TB-ME-2011-[redacted]. However, at this time, we are unaware of the context and details which the auditors used to evaluated the situation and arrive at their conclusion. Also, as the assets associated with the Churchill Falls Hydro-Electric Development are held in Nalcor, i.e. Churchill Falls (Labrador) Corporation, there is no potential to capitalize the Settlement Payment in the CRF of the Province.

CONCLUSIONS SUMMARY

- Based on our analysis of the transaction, the Department has followed the normal course of action to achieve the transfer of funds and the accounting treatment of the payment as a grant through the Grant & Subsidies account is appropriate and no adjustment to the entry is necessary. By funding the Settlement Payment by way of a grant to Nalcor, the Province must, through the Department, allocate funding for this expenditure on an annual basis for the life of the agreement. The financial statements of the Consolidated Revenue Fund would record an annual grant expense in the amount of $2.0 million (plus 2.5% annual escalation in subsequent years) which would be offset in the Consolidated Summary Financial Statements when consolidating the Nalcor financial statements. The net impact, of recording the grant, to the annual surplus/deficit would be nil. The recording of the liability and the expense would rest with Nalcor.
- If the Province, through the appropriate legal agreements, agrees to accept responsibility for the obligation, a liability of $46.5 million would have to be recorded in the CRF financial statements. The amount reflects the NPV of all the annual Settlement Payments at the point in time the agreement is signed. Details of the amounts are outlined in Appendices II (NPV calculation) and III (journal entries).
- The accounting impacts on the Province, overall, will be the same in the CSFS regardless of if the expense is recorded in the Department or in Nalcor. The presentation of the liability will be different but will still have the same impact on the Net Debt. The liability and expense will have to be recorded in the years ended after November 18, 2011.

OTHER MATTERS FOR CONSIDERATION

While reviewing this issue, other matters were raised that will need further consideration by the Department prior to any decision.

- [redacted]
- If the Province were to assume liability, consideration has to be given to who would be administering the process to determine the amounts to be deducted from the Settlement Payment. Per section 2.2 and 2.3 of the Redress Agreement, there are reductions for amounts to be paid to Newfoundland and Labrador Hydro and other reductions that are to be calculated prior to making the payments.
- Consideration has to be given to who would be responsible for the requirements noted as per section 2.10 in relation to the Settlement Payment Statement and the signed certificate.
- Consideration has to be given to Nalcor's financial obligations to the Innu under the Redress Agreement as there are other obligations beyond the Settlement Payment, especially those obligations beginning in 2041.
- Consideration has to be given to the comments made by Nalcor's auditors as to the inclusion of the Settlement Payments in the capitalized project costs of the Muskrat Fall's development.

SCHEDULE I:

RELEVANT CICA HANDBOOK EXCERPTS

Emphasis added throughout.

LIABILITIES, Section PS 3200

.05 Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. Liabilities have three essential characteristics:

(a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;
(b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
(c) the transactions or events obligating the government have already occurred.

CONTRACTUAL OBLIGATIONS, Section PS 3390

.03 Contractual obligations are obligations of a government to others that will become liabilities in the future when the terms of those contracts or agreements are met.

.04 Contractual obligations are distinct from liabilities as there has been no past transaction or event obligating the government to a future sacrifice of economic benefits at the financial statement date. Until a transaction or event occurs under a contract, a government does not have a liability. Disclosure of information about contractual obligations relates to the unperformed portion of those contracts.

GOVERNMENT TRANSFERS, Section PS 3410 (Archived Pronouncements)[1]

GRANTS

.34 Grants include such transfers as: cultural grants, scholarships, research grants and regional development grants. In most cases, recipients have to apply for the money or meet some eligibility criteria; however, in contrast to entitlements, applying or meeting eligibility criteria does not guarantee that the recipient will receive the money. The government still has discretion to decide whether or not to make the transfer. There is usually a ceiling on the total amount that may be transferred under a particular grant program and some grant recipients are subject to performance or reporting requirements.

.35 Because grants are discretionary, the government is not obligated until the grant is approved. As with other government expenditures, there must be legislative approval for the grant or for the program under which the grant is made. The elected body approves spending limits for specific programs or departments and delegates the authority to approve specific payments under that authority to the relevant elected or appointed official. Both levels of approval are required before the grant is authorized to be paid and becomes a liability of the transferring government.

.36 Spending authority usually relates to grants for the current fiscal year only. Amounts that relate to future periods, such as commitments to provide grants towards capital projects over a number of years, usually require additional approval in future budgets.

37 At some point, the government, or a representative who has been given the authority to do so, commits the government to make the transfer. At that point, the transfer becomes, in effect, non-discretionary and would be an obligation of the government once eligibility criteria, if any, are met.

.38 ¨ Liabilities should be recognized by the transferring government for any unpaid, authorized grants at the end of the accounting period for which the recipients have met eligibility criteria, if any, prior to the end of that period. [NOV. 1990]

.39 ¨ Receivables should be recognized by the recipient government for those grants authorized by the transferring government prior to the end of the accounting period but not yet received, if the recipient government has met eligibility criteria, if any, prior to the end of that period. [NOV. 1990]

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1 Revised PS 3410 applies to fiscal periods beginning on or after April 1, 2012.

APPENDIX I:

JOURNAL ENTRIES REQUIRED FOR THE RECORDING OF THE GRANT EXPENDITURE

Purpose: - To illustrate journal entries needed in each year to account for payments to the Innu of Labrador.

Journal entries
Needed in each year (note 1)

Journal entries	Accounts	Dr	Cr
Inception	Grants & Subsidies	2,000,000	
	Cash		2,000,000
2012	Grants & Subsidies	2,050,000	
	Cash		2,050,000
2013	Grants & Subsidies	2,101,250	
	Cash		2,101,250

Notes

1 First three years included for illustration

Nalcor could record the grant as follows:

Journal entries
Needed in each year

Journal entries	Accounts	Dr	Cr
Inception	Cash	2,000,000	
	Grant Revenue		2,000,000
2012	Cash	2,050,000	
	Grant Revenue		2,050,000
2013	Cash	2,101,250	
	Grant Revenue		2,101,250

APPENDIX II:

NET PRESENT VALUE OF THE LIABILITY AND AMORTIZATION (IF RECORDED IN THE CRF)

Purpose:
- To determine the net present value (NPV) of future payments.
- To determine the interest expense and principal reduction in each year.

Calculations

Assumptions

Discount rate	4.54%
Current year	2012
Starting payment	$2,000,000
Annual increase	2.50%
Starting amount	$46,493,964

Net present value

	Year	Starting balance	Payment	PV of payment	Interest expense	Principal reduction	Ending balance
	2012	$46,493,964	$2,000,000	$2,000,000	$0.00	$2,000,000	$44,493,964
	2013	$44,493,964	$2,050,000	$1,960,972	$89,028.12	$1,960,972	$42,532,992
	2014	$42,532,992	$2,101,250	$1,922,705	$178,544.65	$1,922,705	$40,610,286
	2015	$40,610,286	$2,153,781	$1,885,186	$268,595.69	$1,885,186	$38,725,101
	2016	$38,725,101	$2,207,626	$1,848,398	$359,227.85	$1,848,398	$36,876,703
	2017	$36,876,703	$2,262,816	$1,812,328	$450,488.24	$1,812,328	$35,064,375
	2018	$35,064,375	$2,319,387	$1,776,962	$542,424.54	$1,776,962	$33,287,413
	2019	$33,287,413	$2,377,372	$1,742,287	$635,084.96	$1,742,287	$31,545,126
	2020	$31,545,126	$2,436,806	$1,708,287	$728,518.34	$1,708,287	$29,836,839
	2021	$29,836,839	$2,497,726	$1,674,952	$822,774.11	$1,674,952	$28,161,887
	2022	$28,161,887	$2,560,169	$1,642,267	$917,902.37	$1,642,267	$26,519,620
	2023	$26,519,620	$2,624,173	$1,610,219	$1,013,953.89	$1,610,219	$24,909,401
	2024	$24,909,401	$2,689,778	$1,578,798	$1,110,980.14	$1,578,798	$23,330,603
	2025	$23,330,603	$2,757,022	$1,547,989	$1,209,033.34	$1,547,989	$21,782,614
	2026	$21,782,614	$2,825,948	$1,517,781	$1,308,166.44	$1,517,781	$20,264,833
	2027	$20,264,833	$2,896,596	$1,488,163	$1,408,433.20	$1,488,163	$18,776,670
	2028	$18,776,670	$2,969,011	$1,459,123	$1,509,888.22	$1,459,123	$17,317,547
	2029	$17,317,547	$3,043,237	$1,430,650	$1,612,586.92	$1,430,650	$15,886,897
	2030	$15,886,897	$3,119,317	$1,402,732	$1,716,585.61	$1,402,732	$14,484,165
	2031	$14,484,165	$3,197,300	$1,375,359	$1,821,941.55	$1,375,359	$13,108,807
	2032	$13,108,807	$3,277,233	$1,348,520	$1,928,712.89	$1,348,520	$11,760,287
	2033	$11,760,287	$3,359,164	$1,322,205	$2,036,958.82	$1,322,205	$10,438,082
	2034	$10,438,082	$3,443,143	$1,296,403	$2,146,739.50	$1,296,403	$9,141,678
	2035	$9,141,678	$3,529,221	$1,271,105	$2,258,116.16	$1,271,105	$7,870,573
	2036	$7,870,573	$3,617,452	$1,246,301	$2,371,151.12	$1,246,301	$6,624,272
	2037	$6,624,272	$3,707,888	$1,221,980	$2,485,907.81	$1,221,980	$5,402,292
	2038	$5,402,292	$3,800,585	$1,198,135	$2,602,450.81	$1,198,135	$4,204,158
	2039	$4,204,158	$3,895,600	$1,174,754	$2,720,845.92	$1,174,754	$3,029,403
	2040	$3,029,403	$3,992,990	$1,151,830	$2,841,160.14	$1,151,830	$1,877,574
	2041	$1,877,574	$4,092,815	$1,129,353	$2,963,461.78	$1,129,353	$748,220
31-Aug	2041.666	$748,220	$2,792,926	$748,220	$2,044,705.10	$748,220	$0
			$90,598,332	**$46,493,964**	**$44,104,368**	**$46,493,964**	

NPV of future payments: **$46,493,964**

APPENDIX III:

ILLUSTRATION OF JOURNAL ENTRIES TO RECORD LIABILITY AND ANNUAL PAYMENTS IN THE CRF

Purpose: - To illustrate journal entries needed in each year to account for payments to the Innu of Labrador.

Journal entries	Accounts	Dr ($000s)	Cr ($000s)
Inception (Note 1 & 2)	Allowances & Assistance	46,493,964	
	Long term note payable		46,493,964
Needed in each year (note 3)			
2012	Long term note payable	2,000,000	
	Interest/discount expense	0	
	Cash		2,000,000
2013	Long term note payable	1,960,972	
	Interest/discount expense	89,028	
	Cash		2,050,000
2014	Long term note payable	1,922,705	
	Interest/discount expense	178,545	
	Cash		2,101,250

Notes

1 Discount rate of 4.54%
2 Consistant with the treatment of settlement payments made through the Department of Justice
3 First three years included for illustration

- The table above reflects the journal entries required if the liability were recorded in the CRF. However, they would be the same if recorded by the Province through the CRF financial statements or by Nalcor through their annual financial statements. Account descriptions may be different.

- **The journal entries as reflected above indicate those necessary to record the liability and annual payments. The amounts reflected will be subject to change depending upon the entity recording the liability, the timing of the payments, the discount rate used and period over which the liability is recorded.**