MEMO

TO: MEMBERS OF THE BOARD OF DIRECTORS, NALCOR ENERGY

FROM: ROB HULL
DIRECTOR, COMMERCIAL AND STRATEGY

SUBJECT: **RATE MITIGATION UPDATE**

DATE: SEPTEMBER 11, 2018

CONFIDENTIAL AND COMMERCIALLY SENSITIVE

PURPOSE

The purpose of this memorandum is to provide an update for the Board of Directors of Nalcor Energy ("Nalcor") on the rate mitigation activities being pursued by Management. In addition to providing a general status update, Management is providing a comprehensive overview of developments that have impacted the outcomes and shaped the actions taken to date.

HISTORICAL CONTEXT

In May 2017, the Nalcor CEO endorsed the key terms and conditions for the provision of an "all needs" power purchase and optimization agreement ("All Needs Agreement") between Nalcor and Newfoundland and Labrador Hydro ("Hydro") whereby Nalcor, via its non-regulated electricity operations, would provide Hydro with electricity required for Hydro to serve its customers at a rate to be pre-determined by the Province. To implement the All Needs Agreement, Nalcor proposed to establish a pool of funds that would accumulate the value achieved from rate mitigation activities (Holyrood fuel displacement, market optimization and ponding, and enhanced export sales) that could be utilized, in combination with rate subsidization, to reduce rates following the in-service of the Muskrat Falls Plant.

In July 2017, as implementation of the All Needs Agreement required a high level of support from and coordination with the Province, the Nalcor CEO proposed to the Department of Natural Resources ("DNR") the establishment of a Rate Mitigation Committee ("RMC") comprised of representatives from Nalcor, Hydro, and the Province. The RMC subsequently endorsed a Charter and Terms of Reference embodying the key principles of the All Needs Agreement.

Also in July 2017 and in accordance with the principles of the All Needs Agreement, Hydro filed its 2017 General Rate Application ("GRA") proposing to set rates for 2018 and 2019 based on the continued supply of No. 6 fuel consumed at Holyrood such that savings realized from off-island power purchases, including recall energy from Churchill Falls, would be set aside in a deferral account ("Holyrood Deferral") to smooth the transition to higher post-Muskrat Falls rates.

In September 2017, DNR engaged the Department of Justice, Nalcor and Hydro to identify specific support requirements from the Province. To implement the Holyrood Deferral in accordance with Hydro's proposal, a requirement for an Order in Council ("OIC") was identified directing the Board of Commissioners of Public Utilities ("PUB") to establish the Holyrood Deferral to offset future rates following the in-service of the Muskrat Falls Plant in accordance with further guidance from the Province.

Nalcor was advised a Cabinet Paper was submitted supporting the establishment of the Holyrood Deferral. However, the OIC was not provided. In October 2017, and in the absence of an OIC directing otherwise, Hydro responded to Requests for Information related to its GRA using commercial assumptions regarding the purchase of off-island power supplies and bringing non-regulated power purchase arrangements, including use of the recall energy, into the purview of the PUB. Following a number of enquiries from Nalcor and Hydro on the status of the OIC and during discussions related to the proposed Reference Questions in November, the Province advised that legislative support requirements to implement the All Needs Agreement and to pursue the rate mitigation initiatives would not be forthcoming.

Despite the lack of policy direction from the Province, Nalcor and Hydro have continued to move forward to implement the necessary commercial arrangements and regulatory approvals to maximize value creation. Efforts are challenging and time consuming. The outcomes are not as intended, or remain uncertain, as outlined below.

IMPLICATIONS AND OUTCOMES

Holyrood Deferral

Absent direction from the Province, Hydro's proposal to establish the Holyrood Deferral came into the purview of the PUB and became a central issue in the GRA. The establishment of the Holyrood Deferral was opposed by intervening parties and the GRA process was delayed. Hearings finally commenced in April and it became evident during the process that as long as Hydro maintained its application for the Holyrood Deferral, a settlement was highly unlikely and a protracted GRA would place significant schedule risk on Hydro's upcoming regulatory applications which must be filed prior to the in-service of the Muskrat Falls Plant. Accordingly, Hydro entered into a settlement agreement in July 2018 reflecting forecasted savings from off-island power purchases in 2018 and 2019 rates. Consequently, these savings are no longer available for future rate mitigation. Further, by reducing rates in 2018 and 2019, the degree of "rate shock" increases upon the in-service of the Muskrat Falls Plant, when project costs become recoverable.

Two outcomes with potential financial consequences for Nalcor and the Province remain outstanding, both of which can result in losses recognized by Nalcor and therefore the Province on a consolidated basis over the 2018-2020 period:

- Recovery of the operating and maintenance costs for the Labrador-Island Link ("LIL") and the Labrador Transmission Assets ("LTA"), which without policy direction requires approval by the PUB; and

- The establishment of arrangements with Hydro for creation of a deferral account relating to the financing costs incurred during the interim period of use of the LIL and LTA, with recovery from Island customers occurring following the full commissioning of the Muskrat Falls Plant.

Savings realized to date from off-Island power purchases to displace Holyrood and use of the gas turbines are presented in the figure below.

[redacted]

Market Optimization and Ponding Arrangements

The All Needs Agreement proposed the net proceeds obtained from market optimization and ponding activities be accumulated in Nalcor as part of the pool of funds to mitigate rates to levels pre-determined by the Province. Absent policy direction, Hydro determined it would require approval from the PUB to conduct optimization and ponding activities pursuant to its legislation. Hydro, Nalcor Energy Marketing ("NEM") and Muskrat Falls Corporation ("Muskrat") (collectively "the Parties") also determined they will need to execute a long-term commercial arrangement regarding the pooling of their respective assets to create and share value from the activities, which will now be subject to the approval of the PUB.

Becoming interconnected earlier this year, the Parties determined the primary priority would be making an interim application to the PUB to conduct the optimization and ponding activities required pursuant to Hydro's legislation to allow the market optimization and ponding activities to commence and therefore start to capture economic value. However, with the GRA underway, Hydro wished to avoid having these market activities become subject to the current GRA hearings, and therefore the application could not proceed until the hearings were substantially completed in August 2018. An interim application was filed on August 23, 2018. The application proposed that the market activities be approved to commence with the net proceeds held in a deferral account within Hydro. Hydro would make a future application(s) on commercial terms and the disposition of the deferral account, including value sharing between Hydro and NEM, and the long-term commercial arrangement to be negotiated between the Parties.

Until PUB approval is obtained, there is a continued delay in the commencement of market optimization and ponding activities, resulting in lost economic value. The value sharing mechanism will require approval of the PUB, which does not represent NEM and Muskrat interests (i.e. taxpayer interest) in the arrangements. Accordingly, there is uncertainty as to how value sharing will be determined, and whether value created will be available for rate mitigation purposes following the in-service of the Muskrat Falls Plant or reflected in current rates, further increasing rate shock.

OTHER UPDATES

Export Markets

In 2018, Nalcor and NEM continued to engage with market participants and government officials in the Maritimes, Ontario and the northeast United States to assess opportunities to enhance the value of electricity exports. [redacted]

Transmission Assets

In July 2018, the Province requested that Nalcor prepare an indicative value analysis related to the fair market value of the transmission and distribution assets of Hydro. The Province wished to determine whether a sale of such assets may provide a rate mitigation benefit. The analysis indicated a price would have to be obtained significantly in excess of observed market transactions to provide such a benefit. The Province continues to evaluate the merits of such a sale, and a working committee has been struck between the Province, Nalcor, and Hydro to support these efforts.

Reference Questions

On September 5, the Province released the terms of reference for the PUB to examine options to mitigate rates, including options to reduce the rate impacts resulting from the Lower Churchill Project up to the year 2030, and including both cost savings and revenue opportunities involving the electricity-related activities of Nalcor and its subsidiaries. The PUB was asked to deliver an interim report by February 15, 2019 and a final report by January 31, 2020. To support this analysis, the Provincial Government is recommending that the PUB engage the Consumer Advocate.

Rate Subsidization

Various analyses have been requested by the Province to assist in determining a rate subsidization strategy following the in-service of the Muskrat Falls Plant. Nalcor and Hydro continue to cooperate with the Province in responding to these requests.