Opening Remarks for Denise Hanrahan,
Deputy Minister of Finance
Muskrat Falls Inquiry Phase III
Tuesday, July 16, 2019

- Good morning. Thank you for the opportunity to provide information to the Inquiry regarding the two overarching questions posed by Commission Counsel.
- The first question posed for Panel members is: "What are the consequences of paying for Muskrat Falls through increased power rates?"
- Basic economic theory regarding price elasticity holds that when the price of a good or service increases, it generally means that consumption (i.e. demand) of that good or service decreases. My fellow panelists address this in speaking to their areas of expertise.
- The residential energy rate on the Island portion of this province is currently 12.3 cents per kilowatt-hour. Rates naturally tend to go up over time due to operational and inflationary pressures. The cost of electricity for Island residential ratepayers is likely to increase this year by 4% to 12.9 cents per kilowatt-hour, based on ongoing general rate applications by Newfoundland and Labrador Hydro and Newfoundland Power. This 4% increase is not related to the Muskrat Falls Project. Assuming inflation of 2.25% per year, the cost of electricity is expected to rise to about 13.5 cents

per kilowatt-hour by 2021. Again, such a cost increase would not be related to the Muskrat Falls Project.

- A rate of 13.5 cents is expected to be the lowest, or among the lowest, of domestic electricity rates in Atlantic Canada by 2021, which average is expected to be between 16 and 18 cents per kilowatt-hour by that time. 13.5 cents is also well below the rate of 16.1 cents per kilowatt-hour that was projected for 2020 when the Muskrat Falls Project was sanctioned in 2012 and expected to be operational by 2018.

- The 2021 expected rate of 13.5 cents per kilowatt-hour is the premise of Government's rate mitigation plan, as released in April 2019. The plan is designed to ensure that ratepayers and taxpayers will not pay any incremental costs relating to the Muskrat Falls Project. Electricity rates and taxes will not rise as a result of the Project.

- It is reasonable to ask how that's possible since someone has to pay the Project's $12.7 billion dollar cost. The funding requirement for 2021 is $725.9 million, calculated on an accrual basis.

- For those who are interested, details of the rate mitigation plan and how that amount is to be funded can be found on Government's website. I will now summarize the key components of the plan by summarizing its five components.

- Net operational savings from Newfoundland and Labrador Hydro is comprised of $178.2 million from net fuel savings at the Holyrood Thermal Generating Station and other regulatory processes as our Province transitions to Muskrat Fall's power. It is expected that non-Muskrat Falls regulated revenue of Newfoundland and Labrador Hydro will increase by an estimated inflation rate of 2.25% in 2020 and 2021. This approximates Holyrood savings, with the actual savings being dependent on the timing of Holyrood's closure and fuel prices changes.

- The provincial investment of $249.1 million includes $49.1 million realized from selling surplus energy that is either recaptured from Churchill Falls or is surplus energy from Muskrat Falls. The other $200 million is the annual amount committed in past budgets funded by Nalcor dividends starting in 2021. This contribution comes from any Nalcor return on equity realized from the Muskrat Falls Project as well as from revenues from other Nalcor lines of business, such as Nalcor's existing holdings in oil and gas projects.

- Reducing expenses by $39.4 million will also contribute in paying the cost of Muskrat Falls. Specifically, the PUB interim report identified annual cost savings from Nalcor restructuring as well as opportunities to reduce operations and maintenance costs. Reductions in diesel fuel consumption in the 20 isolated systems across the Province can also be achieved through the installation of renewable energy solutions, which can be funded from federal funding opportunities.

- Raising revenues will contribute $59.2 million toward rate mitigation. Switching Government buildings, such as health care facilities and Memorial University, to electricity as existing furnaces and boilers reach the end of their useful life is a valuable opportunity to increase the demand for electricity. There is federal funding available to help with conversion costs. Sale of surplus energy to new customers such as data centers is another revenue opportunity, as is offering firm capacity to large customers, which is a higher value product than spot export energy sales. Holyrood performance credits, which are earned for reducing its greenhouse gas emissions below targets, can be sold to other industrial facilities. While Holyrood won't be fully decommissioned for another few years, it won't be burning fuel for base load generation once Muskrat Falls comes online.

- And finally, managing the financial structure of the Muskrat Falls Project was a federal commitment achieved when the new agreement on the Atlantic Accord was announced in April 2019. A formal process is underway to evaluate all options as presented in the PUB Interim Report, to review the cost drivers as well as the revenue opportunities, and to consider how the Muskrat Falls Project can further the climate change commitment issued by both Canada and our Provincial Government.

- The PUB Interim Report indicated there are significant opportunities for rate mitigation associated with the Project's financing, and they have suspended their work while those inter-government discussions are ongoing.

- Government is confident in the rate mitigation plan put forth, and is focused on ensuring that this plan is achieved. The plan is the result of years of detailed and focused work by dedicated teams from many backgrounds, in which work I have personally been engaged. There were many options to consider - the key was choosing those options likely to have the least possible impact on the people of our Province while keeping the Province's fiscal situation in mind. The rate mitigation follows from Government actions such as the restoration of oversight by the PUB and Canada's commitment to assist with rate mitigation. The rate mitigation plan aligns with the interim PUB Report released in February 2019, which validates many of the concepts included in the plan.

- Any plan has risks, and unforeseen challenges sometimes occur. It would be unrealistic to ignore that possibility. Government will continue to assess its rate mitigation plan and revise its approach as needed on a regular basis when such challenges arise. This is common for all Government financial plans, including our annual budget process. Finalization of the rate mitigation plan will occur once the PUB's final report is submitted in January 2020. This timeline allows for consideration well before any payments for Muskrat Falls come due, which is when the fourth generation unit comes online in late 2020. 2021 will be the first full year of operation of the Muskrat Falls Project.

- The second question posed for Panel members is: "What are the consequences of paying for Muskrat Falls from general tax revenue, and what are the consequences of increased taxes/fees, reduced service levels or an increased deficit?"

- If Government decides to spend money on anything not currently in the fiscal forecast or decides to stop collecting an existing revenue or fee, the most likely result is an impact on the deficit, on net debt, or on borrowing.

- Government can fund new spending or manage with less revenue in three ways:
    - Government can neutralize the impact on the deficit by increasing its revenue either through increasing provincial taxes and fees or by utilizing federal funding;
    - Government can neutralize the impact on the deficit by reducing costs elsewhere or by trading expenditures elsewhere for the new ones or as an offset to the revenue loss; or
    - Government can increase the deficit and borrow what is needed for the new spending or to address the loss of revenue.

- Regardless of what the spending is for, the reality is that new spending generally impacts the Province's fiscal position negatively if it cannot be countered by new revenues or by other expense savings.

- The state of the Province's fiscal position is communicated three times a year – at Budget tabling in the spring, at the issuance of the audited Public Accounts in the fall, and during the mid year fiscal update, which usually follows issuance of the Public Accounts. Numerous entities comment on those reports, including the provincial Auditor General as well as national publications such as the federal Parliamentary Budget Officer reports, C.D. Howe reports, and research organizations. Bond rating agencies are keen observers and key commentators, as they offer an opinion on the Province's creditworthiness.

- There are several key indicators of our financial position. As of Budget 2019, the Province was projecting a net debt of $13.8 billion dollars, or approximately $26,300 per capita. This figure includes $14.5 billion in net borrowings, which is generally considered tax-supported debt. It does not include any self-supporting utility debt, which would be recorded on Nalcor's consolidated financial statements. The Muskrat Falls asset would be recorded on Nalcor's statements as well.

- Government intends to use the rate mitigation plan they presented to avoid impacts on the provincial deficit or debt. The plan involves federal government support worth $200 million, Nalcor dividends contributing $200 million, and various other revenue sources and cost savings providing the $326 million balance. Successful implementation of Government's rate mitigation plan, in conjunction with the multi-year fiscal strategy to return to surplus in 2022/23, is key to maintaining the Province's bond rating.

- Given the importance to the Province of the rate mitigation plan and the return to surplus plan, my focus is on implementing these plans effectively and efficiently. Plans change and we continue to adapt to those changes by providing reliable analysis and policy advice. We have come to accept that not all things in the future can be accurately forecasted – oil prices, exchange rates, and interest rates just to name a few - so we do not focus on the hypothetical beyond the next few years. We are focused on what is probable in the near term. Government's rate mitigation plan and return-to-surplus plan are included in the annual Budget documents as projections to 2022/23.

- The Commission requested that I provide some information on the provincial tax system. A comprehensive review was submitted to Government on November 30, 2018 by a five member independent committee who considered the tax capacity of the Province in light of issues such as competitiveness, economic impacts, and our fiscal situation.

- The committee's summary and background reports are posted on Government's website. I encourage anyone who is interested to consider the committee's comprehensive report as it uses common language to provide a practical assessment of a very technical and complex subject.

- I will now highlight some of the key characteristics of our tax system and utilize Budget 2019 to provide context.

- Who a 'taxpayer' is depends on one's perspective – it could be someone who pays personal income tax on earnings; it could be someone who pays sales tax when buying goods or services; it could be a business that pays taxes on profits or on payroll or on production; it could be someone who pays a combination of taxes when they purchase gas or cigarettes, as those goods each have their own tax along with HST.

- A full listing of provincial revenue sources is provided when the annual budget is tabled. From a provincial treasury perspective, taxation alone represents about 50% of the total revenues the Province collects (when the one time Atlantic Accord funding is removed); in Budget 2019, taxation is expected to generate $3.9 billion dollars a year. Taxation is an essential source of funding for provincial programs and services. For comparison, offshore oil revenues are worth $1.1 billion, which is 14% of total revenues.

- The largest component of tax revenues is provincial personal income tax, which represents $1.6 billion. While in 2016 roughly 425,000 people filed a tax return in the Province, only about 277,000 actually paid income tax. This means that only 53% of the population actually pays income taxes.

- From an income level perspective, in 2016 approximately 51% of income tax filers had taxable incomes of $30,000 or less, and they paid approximately 4% of the total personal income tax collected. Conversely, 49% of tax filers paid over 96% of income taxes collected. Another indication of the structure of our income tax base is that less than 7% of tax filers had a taxable income over $100,000, while more than 20% had a taxable income below $10,000.

- In 2019-20, our second largest tax source is sales taxes, which are the Province’s 10% share of HST and any retail sales tax on the private sale of used vehicles and insurance premiums. These are considered consumption taxes, which economists consider a preferred taxation method because they distort the economy less than income tax. Sales tax represents $1.2 billion, or 15% of the Province's total revenue (when the one time Atlantic Accord funding is removed).

- The next two highest tax sources are corporate income taxes, worth $411 million, and gasoline tax, worth $186 million. Other taxes the Province collects include tobacco tax, payroll tax, insurance companies tax, mining tax, corporate capital tax, carbon tax, and cannabis tax.

- On the topic of reducing government services, the current Government has focused on a balanced approach.

- The Finance and other Departments and have supported this administration in reviewing service delivery and finding efficiencies, and we continue to do so. The focus is not on reducing services, but on delivering services differently.

- In closing, I note that questions can always be posed based on hypothetical situations. I've sought to make it absolutely clear that as Government has announced its plan for managing power rates, the Department of Finance and other departments are working tirelessly to implement that plan.

- Thank you.