

## Memorandum prepared by Nalcor Energy for the Commission of Inquiry regarding the Muskrat Falls Project

August 14, 2019

During the testimony of the Premier on July 4, 2019 (transcript pages 7-8) and July 5, 2019 (transcript pages 28-29), the Commissioner of the Muskrat Falls Inquiry (“**Commissioner**”) enquired regarding oversight or verification of the determination of the amount of Project costs to be paid through, commercial arrangements, by consumers of electricity in the province of Newfoundland and Labrador. This memo addresses the ability of Newfoundland and Labrador Hydro (“**Hydro**”) to challenge or dispute costs associated with construction and operation of the Muskrat Falls Project (“**MFP**”).

### **BACKGROUND**

During 2011 through 2013, Nalcor in consultation with the Government of Newfoundland and Labrador (“**GNL**”) and Government of Canada (“**Canada**”), developed a financing structure for the MFP. The structure contemplated cash flows being generated from the domestic sale of electricity and use of certain transmission assets. These cash flows would then be used to pay for the MFP. These arrangements were initially described in the GNL Commitment Letter of October 2011. Subsequently, a series of agreements (“**Revenue Agreements**”) were developed by Nalcor and Hydro (with oversight of GNL and Canada) creating the commercial arrangements giving rise to such cash flows. GNL then developed a legislative framework directing the Public Utilities Board of Commissioners (the “**Board**”) to allow Hydro to recover MFP costs arising from the Revenue Agreements from Island interconnected rates.

We begin with a brief summary of the MFP legislative framework, which includes:

- (i) Bill 61 (as promulgated) – amending the *Electrical Power Control Act, 1994* (“**EPCA**”) and the *Energy Corporation Act and Hydro Corporation Act, 2007*, including amending the EPCA to allow the Lieutenant Governor in Council to provide direction to the Board regarding duties, procedures and directives on the exercise of the PUB’s duties with respect to MFP.
- (ii) MFP Exemption Order (120/13) (“**Exemption Order**”) – exempting certain expenses and activities of Hydro, Muskrat Falls Corporation (“**MFCo**”), Labrador Transmission Corporation (“**LTC**”) and LIL Parties (as defined) from the application of the *Public Utilities Act* and Part II of the EPCA; and
- (iii) Order in Council OC2013-343 (“**OIC**”) – s.5.1(2) of the EPCA directing the PUB to adopt a policy the OIC was authorized pursuant to s.5.1(2) of the EPCA directing the PUB to adopt a policy that certain expenditures, payments or compensation paid directly or indirectly by Hydro to the LCP Project entities or a system operator be included as costs, expenses or allowances and be recovered in full by Hydro in Island interconnected rates charged to the appropriate classes of ratepayers.

The MFP legislative framework designed by the Government of Newfoundland and Labrador (“**GNL**”) to ensure cash flow generated from MFP would fully service its underlying financing and was an essential component of achieving an ‘investment grade’ rated project financing for MFP, as identified by the credit rating agencies. This also became a condition precedent of the Federal Loan Guarantee provided by Canada for the MFP financing and supported a

commitment made by GNL to Canada under the associated Inter-Governmental Agreement. The OIC is the starting point in determining whether a cost is one contemplated by the MFP legislative framework. To qualify, Section 1 of the OIC provides that an expenditure, payment or compensation must be paid directly or indirectly by Hydro under an agreement or arrangement to which the Exemption Order applies to one of:

- a LIL Party,
- the system operator, in respect of a tariff for transmission services or ancillary services in respect of the LIL that otherwise would have been made to a LIL Party, or
- MFCo for electrical power or energy forecasted by MFCo or Hydro for use within the province, whether or not actually delivered, consumed or stored within the province, GHG credits or transmission services and ancillary services and obligations of Hydro to ensure MFCo and LTC meet financing arrangements related to the construction and operation of Muskrat Falls Plant (“**MF Plant**”) and LTA.

Section 2 of the OIC states that costs, expenses or allowances of Hydro described in Section 1 and the rates for Hydro established by the Board pursuant to the direction shall not be subject to subsequent review, and shall persist without disallowance, reduction or alteration of those costs, expenses or allowances or rates, throughout any processes for any public utility, including Newfoundland Power Inc, or any other process under the EPCA or the Public Utilities Act.

#### **A. TFA Payments**

The Transmission Funding Agreement (“**TFA**”) dated 29 November 2013 is a Revenue Agreement between Hydro, Labrador-Island Link Operating Corporation (“**LIL Opco**”) and Labrador-Island Link Limited Partnership (“**LIL LP**”). Under the TFA, Hydro pays for the construction and operation costs of the Labrador-Island Link (i.e. HVdc facilities at Muskrat Falls and Soldiers Pond, HVdc transmission line between those stations, the Strait of Belle Island subsea cables, related HVdc switching stations, synchronous condenser plant at Soldiers Pond and AC switchyard at Soldiers Pond) through “TFA Payments”.

TFA Payments commence on commissioning of the LIL and are absolute, unconditional and irrevocable until the initial financing is paid in full and comprise of:

- (a) a payment of “Rent”, which shall be sufficient to recover:
  - (i) annual depreciation on the capital cost of the LIL;
  - (ii) annual depreciation on sustaining costs of the LIL;
  - (iii) annual portion of the return on rate base which provides for interest payments and a return on equity capital to LIL Holdco and Emera NL; and
  - (iv) the taxes, administrative costs and financial reserve requirements of the Partnership; and
  - (v) a tax adjustment amount payable to Emera NL,

- (b) operating and maintenance costs of the LIL; and
- (c) \$30,000 per operating year.

To qualify under Section 1 of the OIC, TFA Payments must be paid directly or indirectly by Hydro to a LIL Party, under an agreement or arrangement to which the Exemption Order applies. Our assessment is as follows:

- TFA Payments are payments made directly by Hydro to LIL Opco (i.e. a LIL Party)
- Section 4(1)(c) of the Exemption Order states that Hydro is exempt in respect of any payments paid to a LIL Party and claimed as costs, expenses or allowances by Hydro relating to the design, engineering, construction and commissioning of transmission assets ... from LIL Party or otherwise with respect to the LIL, under .... **transmission funding agreements**, or otherwise. This is precisely what occurs under the TFA.
- Section 4(3) of the Exemption Order states a LIL Party is exempt in respect of any activity, and ... **compensation, or any revenues, proceeds or income**, relating to the following:
  - (a) the design, engineering, planning, construction, commissioning, ownership, operation, maintenance, management and control of the LIL;
  - ....
  - (c) negotiating, concluding, executing and performing any and all agreements for activities referred to in paragraph (a)...;
  - ....
  - (e) any agreements, contracts or instruments necessary or incidental to any activity described in this exemption, including agreements between one or more LIL Party.
- the term "exempt" means the public utility (i.e. Hydro and Opco) or the subject activity is exempt from the application of the *Public Utilities Act*, and Part II of the EPCA

TFA Payments, provided the underlying costs meet the relevant TFA definitions, therefore fall within the scope of Section 1 of the OIC. The Board must allow recovery of such TFA Payments from Island interconnected customers when setting Hydro's rates and no party to a regulatory proceeding may apply to have such costs disallowed, reduced or otherwise altered.

Having said this, Hydro holds audit rights and to the extent it determines a cost is non-compliant with applicable TFA definitions, it may dispute such costs through the dispute resolution procedure. A dispute ought not to be on the basis a cost was not 'least cost' but rather that it was not a project cost as determined by the TFA.

## **B. Base Block Payment**

The Muskrat Falls Power Purchase Agreement ("**PPA**") dated 29 November 2013 is a Revenue agreement between Muskrat Falls Corporation ("**MFCo**") and Hydro and pays for the

construction and operation costs of the Muskrat Falls hydroelectric plant (“**MF Plant**”) and the Labrador Transmission Asset (“**LTA**”).

The PPA contemplates the supply by MFCo of blocks of energy (and associated capacity, green house gas credits and/or ancillary services) attributable to the MF Plant. Upon full commissioning, Hydro shall pay to MFCo at the beginning of each month the “**Base Block Payment**”. The Base Block Payment shall be sufficient to recover, over the 50 years following full commissioning, all costs associated with the MF Plant and LTA, based on an annual supply price determined at full commissioning using a 2% annual escalation factor, including:

- (i) development capital costs to build the MF Plant, which shall provide for the repayment of principal under financing and equity investments;
- (ii) financing costs, which shall include interest;
- (iii) an internal rate of return on equity of 8.4%; and
- (iv) the estimated operating and maintenance costs of the MF Plant paid monthly in advance and trued-up quarterly, which costs include the LTA Payments payable by MFCo to Labrador Transco pursuant to the GIA.

Hydro’s obligation to pay the Base Block Payment is on an absolute, unconditional and irrevocable basis until the initial financing is paid in full, regardless of whether MFCo delivers Base Block Energy.

Should MFCo fail to deliver Hydro scheduled energy, Hydro has the right to assume operational control and perform operating and maintenance activities of the MF Plant. In this event, MFCo shall not be relieved of its other obligations under the PPA and Hydro shall continue to make the Base Block Payments. Hydro may return operational control of the MF Plant to MFCo at any time upon giving MFCo five days notice, in which event MFCo shall assume all operational control and operating and maintenance activities associated with the MF Plant.

To qualify under Section 1 of the OIC, Base Block Payments must be paid directly or indirectly by Hydro to MFCo, under an agreement or arrangement to which the Exemption Order applies, for electrical power or energy forecasted by MFCo or Hydro for use within the province, whether or not actually delivered, consumed or stored within the province, GHG credits or transmission services and ancillary services and obligations of Hydro to ensure MFCo and LTC meet financing arrangements related to the construction and operation of MF Plant and LTA.

Our assessment is as follows:

- Base Block Payments are payments made directly by Hydro to MFCo
- Section 4(1)(a) of the Exemption Order states that Hydro is exempt in respect of any expenditures, payments, or compensation paid to MFCo by Hydro relating to the purchase and storage of electrical power and energy, the purchase of interconnection facilities, ancillary services, and greenhouse gas credits. These are precisely what Hydro purchases from MFCo under the PPA.

- Section 4(2) of the Exemption Order states MFCo is exempt in respect of any activity, and ... **compensation, or any revenues, proceeds or income**, relating to the following:
  - (a) the design, engineering, planning, construction, commissioning, ownership, operation, maintenance, management and control of the MF Plan;
  - (b) producing, generating, storing, transmitting, delivering or providing electric power and energy, capacity, ancillary services, and greenhouse gas credits, to or for Newfoundland and Labrador Hydro or any other person or corporation for compensation;
- Section 4(2) of the Exemption Order states MFCo is exempt in respect of any activity, and ... **compensation, or any revenues, proceeds or income**, relating to the following:
- the term "exempt" again means the public utility (i.e. Hydro and MFCo) is exempt from the application of the *Public Utilities Act*, and Part II of the EPCA for specified activities.

Base Block Payments, provided the underlying costs meet the relevant PPA definitions, fall within the scope of Section 1 of the OIC. The Board must allow recovery of such Base Block Payments from Island interconnected customers when setting Hydro's rates and no party to a regulatory proceeding may apply to have such costs disallowed, reduced or otherwise altered.

Again, Hydro holds audit rights and to the extent it determines a cost is non-compliant with applicable PPA definitions, it may dispute such costs through the dispute resolution procedure. A dispute ought not to be on the basis a cost was not 'least cost' but rather that it was not a project cost as determined by the PPA.

### **C. NLSO – Transmission Service**

Transmission service arrangements between Hydro and the NLSO will emanate from the Multi-Party Pooling Agreement and the consequent transmission service agreements between the NLSO and Hydro. In particular, use of the LIL will be covered by a (i) network integration Transmission Service Agreement ("TSA"), and (ii) point-to-point TSA. The TSA's will include posted rates (i.e. tariffs) designed to recover capital and operating costs of transmission system assets, including the LIL, from users of transmission service. Tariffs will be collected by the NLSO and distributed to transmission asset owners. TFA Payments will be credited against the tariffs and fees otherwise due by NLH to the NLSO in respect of transmission services received over the LIL pursuant to the TSAs.

While the applicable tariffs remain under development, payments under such tariff, as they relate only to the LIL, may also fall within the scope of the OIC.