THE CHURCHILL FALLS CONTRACT: WHAT HAPPENED AND WHAT'S TO COME?

BY JAMES FEEHAN

The fourteenth in a series of articles developed from regular public forums sponsored by the Leslie Harris Centre of Regional Policy and Development. Memorial Presents features speakers from Memorial University who address issues of public concern in the province.

The hydro-electric development at Churchill Falls is an enormous resource, generating tens of millions of megawatt-hours of electricity every year, almost all of which is sold to Hydro-Quebec under a long-term contract. The story of Churchill Falls has been an ongoing aspect of Newfoundland's post-Confederation experience. Since the early 1950s, Churchill Falls has been a matter of hope, disappointment, controversy, debate, conflict, court challenges, and interprovincial friction.

One purpose of this article is to provide the basic facts about the Churchill Falls contract, including the history of its negotiation. That negotiation process produced initially a letter of intent, followed by the contract. In the interim between the letter of intent and the contract, there were substantive changes. Those changes involved the ownership of the facility and the length of the contract and will have enormous future implications. The second purpose of this article is to examine those implications.

The Current Situation

The Churchill Falls facilities are owned and operated by the Churchill Falls (Labrador) Corporation, CFLCo. It is owned by two shareholders: the Newfoundland and Labrador Hydro Corporation, which is a crown corporation of the provincial government, and Hydro-Quebec, a Quebec crown corporation. The former owns 65.8 percent and the latter owns the rest.

CFLCo has a 99-year lease on the Churchill River watershed. The lease is with the resource owner, namely, the government of Newfoundland and Labrador. It was signed in 1961 and is renewable for a further 99 years. Based on those rights, CFLCo developed the site, which now produces approximately 34 million megawatt-hours (MWh) of electricity annually.

Under a 1969 contract, "the" contract, CFLCo sells the bulk of that power, about 30 million MWh, to Hydro-Quebec. The remainder is sold to the iron-ore mines in western Labrador and to Newfoundland and Labrador Hydro. Regarding sales to Hydro-Quebec, the 1969 contract sets the price at $2.50 per MWh which yields about $75 million annually. Based on today's markets, the value of that electricity could be placed at $40 to $60 per MWh, for a total between $1 billion and $2 billion annually.

Both the amount of power that must be sold to Hydro-Quebec and the price have been sore points with successive provincial governments since the mid-1970s. While not a signatory to the contract, the provincial government, citing its rights under the lease, launched legal challenges to the contract during the 1970s. Those challenges failed.

CFLCo itself has never contested the contract.

A Brief History of Negotiations to the Letter of Intent

Soon after Confederation in 1949, Newfoundland's first premier, J. R. Smallwood, was in the United Kingdom and Europe, seeking investors for Churchill Falls and other development projects. In 1953, as a result of those efforts, the British Newfoundland Corporation (Brinco) was formed. It was a consortium of large British concerns, with N. Rothschild and Sons, and Rio Tinto among the key players. In 1958, Brinco established a subsidiary called the Hamilton Falls Power Corporation. Brinco held 80 percent ownership and the Montreal-based Shawinigan Engineering Company took 20 percent. This subsidiary's mandate was to develop

Churchill Falls, then known as Hamilton Falls. After Winston Churchill died in 1965, the Hamilton River was renamed in his honour, and that corporation became the Churchill Falls (Labrador) Corporation.

Churchill Falls was a large project in an isolated area, far from potential markets. CFLCo could not finance it without raising substantial long-term loans. However, potential lenders needed assurance that, once the generating facilities were built, there would be a market for the power. Therefore, CFLCo needed a sales agreement before it could proceed. An obvious potential customer was Hydro-Quebec.

During the early 1960s negotiations with Hydro-Quebec were up-and-down. At times, they collapsed over commercial terms and CFLCo considered other options. The alternatives were either an "Atlantic route" using subsea cables to go around Quebec or selling through Quebec to markets beyond. Smallwood was keen on the Atlantic route but it was too expensive. The Quebec government opposed the latter option.

All this was further complicated by political spats between the two provincial governments. There was resentment in Quebec over the location of the border between the two provinces. On the Newfoundland side, Quebec's decision to nationalize Shawinigan Engineering's shares in CFLCo infuriated Smallwood.

Still, progress was made, especially after Robert Winters took the helm as CEO of both CFLCo and Brinco in 1963. He eased the political issues. He also addressed the nationalization matter by permitting Newfoundland to take a 5 percent interest in CFLCo. And he stood up to demands by Hydro-Quebec for a price as low at $2 a MWh. By the fall of 1966, there was finally a letter of intent. This was a comprehensive document. It contained 26 articles of agreement and addressed all the substantive matters. The letter of intent was a *quid pro quo* agreement.

For Hydro-Quebec, the benefits were:

- a price that was below the cost of any other alternative source;
- a series of price reductions over the term of the contract;
- a price reduction if the capital cost of plant was lower than expected;
- a forty-four year term; and
- around 90 percent of the power.

In return, CFLCo received:

- a commitment from Hydro-Quebec to subsidize CFLCo's interest payments on its borrowings if rates increased from those then prevailing;
- an arrangement under which the two parties would share the exchange rate risk (most of the project was to be financed by borrowing in the United States);
- a price increase if the capital cost of the plant was higher than expected;
- a commitment that Hydro-Quebec would lend funds to it if CFLCo's earnings were not sufficient to pay the interest on its loans; and
- a "completion guarantee" by which Hydro-Quebec would lend money to CFLCo if CFLCo was unable to raise enough funds to complete the project.

In a nutshell, CFLCo agreed to terms that greatly limited its potential profits. Once the facility was built, there would be no mechanism to increase the price for the next forty years, regardless of the future market conditions and operating costs. Given the risks, these terms would have made lenders reluctant to finance the project. Indeed, such risks would likely have stopped CFLCo from proceeding. However, Hydro-Quebec's commitments significantly mitigated those risks.

At the time, all the parties expressed satisfaction with these terms. For instance, Hydro-Quebec's president described the deal as a "life raft" for his corporation. When told of the agreement by CFLCo officials, Smallwood wrote "praise be to God" in his diary. Representatives of Hydro-Quebec and CFLCo signed the letter of intent on October 13, 1966. One signatory for CFLCo was Donald McParland, having replaced Winters, who had resigned. McParland was the lead negotiator thereafter.

The Contract

Almost immediately after the signing of the letter of intent, CFLCo launched an extensive constructive program in order to have first power available to meet Hydro-Quebec's requirements. That program was initially financed by bank loans and shareholders. By then, the shareholders were Brinco, Hydro-Quebec, the Newfoundland and Labrador Power Commission, which held the

provincial government's shares, and Rio Algom (a subsidiary of Rio Tinto.)

Throughout 1967 construction proceeded at a substantial pace. However, negotiations on a final contract based on the letter of intent went slowly. By year's end there was still no agreement. On top of that, CFLCo had largely exhausted its bank credit and other sources of funds, and its main shareholder, Brinco, was in a difficult financial position as well. Without an agreement on a contract, CFLCo could not sell long-term bonds to finance the project, but without such financing it could not continue its construction program much longer.

Around March of 1968, Hydro-Quebec made new demands that were contrary to what had been in the letter of intent.

First, it sought a renewal clause that would require CFLCo to accept a second contract immediately at the end of the first one's term. The letter of intent and all the negotiations up to that point agreed that renewal would be negotiated in the future and depend on mutual agreement on price and other terms. Now, Hydro-Quebec was demanding a fixed price of $2 per MWh for a further 25 years. Hydro-Quebec's risk-reducing commitments would not apply to the renewal period, and it offered no other contract concessions. As one of the CFLCo negotiators wrote at the time, this demand was presented as a "do or die condition."

A second demand related to Hydro-Quebec's commitment to make loans to CFLCo if it ran into financial difficulties. Now, Hydro-Quebec wanted bonus shares in CFLCo if it were ever called upon to make such loans; the more it lent, the more shares it would receive. Also, it wanted the right to buy enough of Brinco's shares to give it majority control of CFLCo in certain circumstances.

Aside from the contract itself, Hydro-Quebec became more involved in CFLCo's long-term financing plan. As part of that plan, CFLCo was going to sell new shares to its four shareholders. Hydro-Quebec demanded to buy enough of those shares so as to bring its ownership position to 25.7 percent. In the circumstances, this actually may have been welcomed by Brinco because its financial health was so strained that it could not afford to purchase the new shares in proportion to its ownership stake.

These demands were made in early March, 1968. By mid-March CFLCo complained to Hydro-Quebec that profitability had been "stripped down to the underwear." Despite some attempts to resist, including making a counter-offer on renewal, before the end of April CFLCo had given in. Negotiations were effectively over. At the same time, Brinco agreed to a voting-trust agreement with Hydro-Quebec under which it would obtain voting control over CFLCo if CFLCo failed to have long-term financing arranged by the end of 1968. This locked Brinco and CFLCo in.

Significantly, these demands had come when CFLCo had exhausted its funding sources, and Brinco, too, was financially strapped. Without a contract, lenders would not be forthcoming. CFLCo was in a financial corner. Given Hydro-Quebec's working knowledge of CFLCo, and the presence of its president on CFLCo's board of directors, this financial situation was known to Hydro-Quebec.

While the deal was effectively done by June of 1968, the final contract was not signed until May of 1969. By that time, Brinco's share of CFLCo was 56.9 percent, Hydro-Quebec stood at 34.2, and the remaining 8.9 was owned by the Newfoundland and Labrador Power Commission.

In 1972, the Smallwood regime ended. The newly elected PC government had a different approach to resource development. It threatened to expropriate Brinco if it did not sell its water rights to the lower Churchill River and its shares in CFLCo. The sale went ahead in 1974. As for the project, it was completed in 1976.

What's to Come

The term of the contract will expire on August 31, 2016. However, the concessions that CFLCo had to make in those final weeks of negotiation have implications well after 2016.

First, there is the renewal clause. On September 1, 2016, a new contract lasting until 2041 automatically comes into effect, without negotiations or even the need for signatures. During that time Hydro-Quebec will pay a fixed price of only $2.00 per MWh. Remarkably, Hydro-Quebec had assessed that price as "an extremely advantageous rate for Hydro-Quebec even at this time" and that was in 1968! At $2 per MWh, future revenues are unlikely to even cover

operating costs let alone the cost of any capital repairs and replacements for the aging infrastructure. In short, CFLCo will lose money on the new contract. However, it is not likely to go bankrupt. Sales of electricity not covered in the contract may generate enough earnings to subsidize those losses.

Secondly, there is ownership. Hydro-Quebec owns 34.2 percent of CFLCo and has had representatives on CFLCo's board of directors since 1964. If the status quo prevails, it will own the same amount in 2041 when the renewed contract expires. Then, CFLCo will have many options for power sales and they will surely be at prices many times greater than $2.00 per MWh. Profits are likely to soar. However, Hydro-Quebec will be entitled to its 34.2 percent of those gains. Moreover, it will presumably have the normal legal rights of a shareholder of a federally incorporated business. Also, CFLCo holds the 99-year lease to the Churchill Falls watershed, a lease that does not expire until 2060 and is renewable for another 99 years. Thus, the status quo means that Hydro-Quebec will benefit from and have a say in Churchill Falls for generations after 2041.

This issue of ownership has always been odd. On at least three occasions Robert Winters had tried to convince Quebec officials that a conflict of interest would arise if Hydro-Quebec was both an owner of CFLCo and its main customer. He even offered to buy back the nationalized shares at a substantial premium. That offer was not taken, and the president of Hydro-Quebec became a member of CFLCo's board of directors. In 1968, the new renewal clause that Hydro-Quebec demanded was extremely advantageous for it and clearly to the disadvantage of CFLCo, a clear case of where the fiduciary interest of one was in apparent conflict with other. This has not changed. As a customer of CFLCo, Hydro-Quebec should want the power at the lowest price; as an owner of CFLCo, Hydro-Quebec should want CFLCo to sell at the highest possible price. The two are at odds. Hydro-Quebec representatives on the CFLCo board can hardly agree with a policy that is in the best interest of CFLCo if that policy is to the disadvantage of Hydro-Quebec.

Are these outcomes really the future of Churchill Falls? What might happen to cause a different future? These questions deserve serious study, but it is worthwhile to sketch a few ideas here.

One possibility is that CFLCo might consider trying to change the renewal clause. Given the circumstances in which it came about, such a court challenge might have merit, or perhaps there is something in law that corrects a contract when benefits become extraordinarily one sided. CFLCo might even decide not to recognize the validity of the renewal clause and leave it to Hydro-Quebec to take legal action. Alternatively, it might opt for a less confrontational approach and seek renegotiation of the renewal contract, a contract that is embarrassingly advantageous for Hydro-Quebec. With Hydro-Quebec officials on CFLCo's board, any of these options seems unlikely, especially considering CFLCo's seeming record of passivity.

If CFLCo will not act then what can the provincial government do? Certainly, there is one thing that it can do after August 2016. It can tax CFLCo. Until then, CFLCo pays a water rental and a horsepower tax under the lease, but is otherwise exempted from provincial taxes. That special tax treatment ends in 2016. Then, existing provincial taxes will apply to CFLCo and new taxes can be levied. Whether this will result in much of a gain depends on the ability of CFLCo to pay and on the extent to which any tax can be passed on to its customers. Whether taxes of any sort can be passed on to Hydro-Quebec is a constitutional question.

Also, the provincial government could act on the ownership quandry. It might buy out Hydro-Quebec's shares in CFLCo. It could even consider expropriating them. After all, Hydro-Quebec's initial stake in CFLCo was acquired in a similar way. Here again, though, there is a constitutional question: under the constitution of Canada can a provincial government expropriate the property of a crown corporation owned by another provincial government? If so, can it do it without compensation?

So, in conclusion, the future is not quite set in stone. However, achieving a better future requires action by either CFLCo or the provincial government. NQ

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