2005

# The Renewal Clause in the Churchill Falls Contract: The Origins of a Coming Crisis

James P. Feehan

Melvin Baker

POLITICAL
ECONOMY
RESEARCH
GROUP

# PAPERS IN POLITICAL ECONOMY

96

Paper No. 96

## "The Renewal Clause in the Churchill Falls Contract: The Origins of a Coming Crisis"

James P. Feehan and Melvin Baker



The UNIVERSITY of WESTERN ONTARIO

The Political Economy Research Group was established in the Faculty of Social Science at the University of Western Ontario in 1988. Its purpose is to foster scholarship, teaching and interdisciplinary research in political economy, with a focus on:

1. the application of economic models and methods to the study of political processes and institutions,
2. the economic impact of political processes and institutions,
3. the influence of economic factors on the formation of public policy and on institutional change,
4. the politics of economic policy making, and
5. the political, social, and economic effects of public policy.

*Co-directors:*
Ronald Wintrobe (Economics)
Robert Young (Political Science)

*Board of Directors:*
Peter Howitt (Economics)
Michael Keating (Political Science)
John N. McDougall (Political Science)
Peter Neary (History)
John Whalley (Economics)

*Staff:*
Yvonne Adams

*For further information:*
Political Economy Research Group,
Department of Economics,
Social Science Centre,
London, Ontario, Canada N6A 5C2
phone: (519) 661-2111, ext. 85231
fax: (519) 661-3666

ISSN: 1181-7151
ISBN-10: 0-7714-2554-6
ISBN-13: 978-0-7714-2554-6

# The Renewal Clause in the Churchill Falls Contract: The Origins of a Coming Crisis*

By

James P. Feehan Ph.D
Professor of Economics
Memorial University

and

Melvin Baker Ph.D
University Archivist and Historian
Memorial University



August 23, 2005

* Thanks are due to Peter Neary for helpful comments and advice. Any errors are solely the responsibility of the authors.

## I. INTRODUCTION

The 1969 power contract between Hydro-Quebec and the Churchill Falls (Labrador) Corporation, CFLCo, has been a matter of considerable resentment in Newfoundland and Labrador. The contract itself concerns the development and subsequent sale of electricity from the huge Churchill Falls hydro site. The contract provides that almost all of the power be sold to Hydro-Quebec on a very long-term basis at an extremely low and declining price.

Since the mid-1970s the government of Newfoundland and Labrador has challenged this contract in a number of ways. It launched legal actions; it has made appeals to Canadian public opinion; it has made requests to the Quebec authorities to renegotiate the contract; and it called on the federal government to assist in finding a resolution. None of these tactics has been successful and the power contract continues to be an on-going source of resentment among the people of Newfoundland and Labrador. The relationship between the two provincial governments also remains difficult, with tension and suspicion lingering in the background and breaking to the forefront of public concern on occasion. For instance, in 2002 a potential agreement between Hydro-Quebec and Newfoundland and Labrador Hydro involving another site on the Churchill River failed. In part, this was due to public criticism that there should be no agreements with Hydro-Quebec unless the dispute over the 1969 contract was resolved. The report of the provincial Royal Commission on Renewing and Strengthening Our Place in Canada (2003; pp.122-125) described the outcome of the contract as inequitable.

Still, Canadians generally and Quebecers in particular are no doubt wary of Newfoundland's on-going complaints about this imbalance. It has been over 35 years since the contract was signed. To date, all attempts by the Newfoundland and Labrador government to have the contract renegotiated have been unsuccessful. In the 1980s two litigations - one to gain access to a larger portion of the energy and the other to test the validity of nullifying the contract by legislative cancellation of the lease for the water rights - failed in the Supreme Court of Canada. Many may ask if it is not time to move on rather than dwell on the past?

A major obstacle to moving on is the contract's renewal clause, which takes effect in 2016. That renewal clause has received practically no public attention and has not been an issue in past litigation. The 44-year term of the contract runs from 1972 to 2016. However, the contract provides for automatic renewal at the expiry date for a further 25-year period with the

terms predetermined. As such it amounts to a contract being "piggy-backed"onto a contract. During the renewal period the price is preset at 2 mills per kilowatt hour. A mill is one-tenth of a cent, so 2 mills is 0.2 cents. Even in the late 1960s, a price of 2 mills was extraordinarily low and not achievable from any new energy source then available to Hydro-Quebec. To put this price more in perspective, in 2004 the average wholesale price of electricity in Ontario was 52.2 mills per kilowatt hour and in 2003 Hydro-Quebec received an average of approximately 84.9 mills for its electricity exports from Quebec.[1] A price of electricity of 2 mills in 2017 with that price fixed until close to the end of 2041 is barely distinguishable from being free. Even in 1969 that price would have been considered extremely low and not achievable from any undeveloped alternative then available in Quebec. Since the amount of electricity involved is approximately 30 million megawatt hours annually, the potential gap between the value of the power and the amount paid to CFLCo was already roughly $1 billion a year by 2004 and rising. If current trends in energy prices continue, that annual gap is likely to be in the billions of dollars by 2017.

There is little doubt that before the expiry date of the contract's term this renewal provision will become a source of serious conflict between the two provincial governments. It could jeopardize attempts to develop other hydro-electric sites along the Churchill River, sites which could be crucially important to central Canada's electricity needs.

Of course the existence of this provision is no news to the parties. But how did such an extraordinarily onerous condition get into the contract in the first place? One might have thought that this question would have been thoroughly investigated by now. That has not happened. In his nearly 400-page tome on Churchill Falls, Smith (1975; p.288) offers no meaningful insight, devoting only a single sentence to renewal. The Economic Council of Canada (1980; p.121) appeared to be puzzled by the renewal provision, noting that it was not required by the financiers and that it was added to the contract at a very late stage. Even in articles in the special 100-page issue of *Forces* (1982) devoted to Hydro-Quebec's perspectives

---

[1] For wholesale electricity prices in Ontario see the web site of the Independent Electricity System Operator, http://www.ieso.ca/imoweb/media/md_prices.asp. For Hydro-Quebec the figure is based on data on p.107 of its 2003 annual report.

on the 1969 contract, there is barely mention of renewal.[2] How anyone would agree to, or ask for, a renewal clause like this is an enigma.

This paper represents the first systematic investigation of that mysterious clause. To carry out this task, the renewal provision cannot be examined in isolation. It is necessary to put it in context by giving due consideration to the process that led to the contract; that is done in Section II. Then, Section III turns to the contract negotiations and the events that specifically led to the renewal clause in its present form and provides insight as to how CFLCo became burdened with this onerous condition. Section IV deals with the implications for the three key parties: Hydro-Quebec as the buyer, CFLCo as the seller, and Newfoundland as the resource owner. Crucially, those implications are assessed based on the circumstances of the late 1960's and not with respect to current and anticipated future electricity prices. Section V provides a brief epilogue and Section VI concludes.

## II. INITIAL PROPOSALS TO LETTER OF INTENT

This section provides some of the essential background. It also reviews the early stages of negotiations, which culminated with the signing of a Letter of Intent in 1966.

### II.1 The Origins of CFLCo

In 1952, in a quest for investors to develop Newfoundland's natural resources, the then premier, Joseph Smallwood, approached leading British bankers and industrialists. The outcome of those efforts was the formation in 1953 of the British Newfoundland Corporation, Brinco. It received extensive land and water rights on the island of Newfoundland and in the Labrador region of the province. One of Brinco's most significant assets was the hydro-electricity potential of the waterfalls on the upper reaches of the Hamilton River, later renamed the Churchill River in 1965.

In 1958 Brinco established a federally incorporated subsidiary, the Hamilton Falls Power Company (HFPCo), which would be renamed CFLCo in 1965. At Brinco's invitation, the Quebec-based Shawinigan Engineering Company took up a 20% interest in HFPCo with the

[2] We can find only brief references to it. See Forces (1982) pages 41 and 99. Neither provides any insight into its origins.

right to maintain that ownership position if the corporation were to expand. Brinco retained the remaining 80%. Shawinigan's expertise in hydro-electric development and prior working relationship with HFPCo were the bases for this partnership. The water rights to the Hamilton Falls were transferred from Brinco to HFPCo, and that corporate entity became the development mechanism.

### II.2 The Political Impediments

Developing the Hamilton Falls would involve considerable challenges. Its magnitude and its distance from major markets - 200 kilometres from the Quebec border and many hundreds of kilometres further from there to large population centres - presented substantial engineering and financial complexities. These technical problems were compounded by two major political factors. Both involved Quebec. That was because the potential market for electricity was either in Quebec or had to be accessed by passing through Quebec.

The first political problem had to do with a boundary dispute that arose prior to Newfoundland becoming a part of Canada in 1949. It concerned the location of the inland boundary on the Labrador Peninsula; Canada's and Newfoundland's claims overlapped. The government of Canada, on the request of and with the participation of Quebec, and the government of Newfoundland brought this question to the Judicial Committee of the Privy Council in London. In 1927 the Committee issued its determination as to where the boundary lay. That ruling ended the dispute between Canada and Newfoundland. Despite this resolution, the boundary remained a politically sensitive topic in Quebec.

The second political obstacle was related to the first in so far as it involved territory. At times, HFPCo explored the option of selling to consumers outside of Quebec, potential customers being Ontario, and especially the US northeast. To do so would entail transmission of electricity through Quebec either using its electricity grid or by building a dedicated power corridor through that province. Under the Canadian constitution, embodied at the time in the British North America Act of 1867 and its subsequent amendments, provincial governments could not interfere or impede another province's trade. Still, Quebec governments were opposed to any attempt to tranship power over their territory without their approval. The political circumstances in Quebec since the late 1950's were such that the federal government was not

anxious to be put in a position in which it would have to confront Quebec over this matter; for more on this see Churchill (1999).

Both these territorial issues were to linger in the background as discussions, talks and negotiations were to take place between Hydro-Quebec and HFPCo during the 1960s. As well documented by Smith (1975), occasionally, they would flare up at the political level, with accusations and counter-accusations between Premier Smallwood and the various Quebec premiers. It is fair to say that both Brinco/HFPCo and Hydro-Quebec officials generally sought to avoid these political conflicts during their negotiations but the political flare-ups did impede progress in commercial negotiations.

**II.3. Early Discussions**

Brinco had first approached Quebec about the potential development of the Hamilton Falls in the mid-1950s but any talks had been sporadic. However, as Smith (1975, 121-125) reports, by early 1961, Brinco officials were convinced that Quebec would be facing a severe power shortage by 1969 and that power from Hamilton Falls could be supplied to Quebec at a price lower than any alternative site available in Quebec. So in March 1961, HFPCo offered 1 million horsepower available from October 1965 under a 25-year contract at a price of 3.5 mills per kilowatt hour at the power plant with an option for another 1 million horsepower at 2.6 mills. While the price was comparable, Hydro-Quebec opted for a preferred site in Quebec.

New possibilities for a commercial agreement arose in September 1962. The federal government announced in its Throne Speech that it would allow long-term contracts for the export of surplus power to expedite the development of major power projects in Canada. This was important because huge projects, such as the Hamilton Falls, required long-term "take or pay"contracts to support their financing. Take-or-pay means that the buyer is obliged to pay for the contracted quantity even if at times it did not use or take delivery of all of it. Allowing long-term export opened up the possibility of such arrangements with buyers in the United States. Either HFPCo might be able to export power across Quebec or it might sell the power to Hydro-Quebec, which could export any portion of it that was in excess of Quebec consumers' demand. Similarly, Hydro-Quebec now would be in a position where, if it did commit to purchase, on a take-or-pay basis, a large quantity of power from HFPCo and found itself with excess power,

then it had the possibility of selling that excess in the US. At the time, some U.S. utilities, notably Consolidated Edison, were expressing interest in importing power.

The prospects for building on the impetus provided by the new federal policy, however, became severely complicated following the December 29, 1962 announcement that the Quebec government would nationalize the privately owned portion of the electricity industry in that province. While non-electrical subsidiaries of these businesses were allowed to remain in private hands, the Quebec government insisted that Shawinigan Engineering transfer its 20% holding in HFPCo to Shawinigan Water and Power, its parent company and one slated for nationalization. Thus, nationalization would encompass those holdings in HFPCo. According to Fullerton (1982, p.46) it was Quebec Premier Jean Lesage himself that wanted this specific transaction carried out.

Premier Smallwood was outraged at Quebec's intentions. In mid-January of 1963, an official of Brinco, David Morgan-Grenville met with Premier Smallwood to discuss this issue. According to Morgan-Grenville's notes, Smallwood was upset over Quebec's reluctance to allow Brinco to discuss with Hydro-Quebec how Hamilton power could be transmitted through that province. Those notes also record that Smallwood reiterated his own threat to nationalize Shawinigan Engineering's 20% interest in HFPCo if "Mr. Lesage persisted in being difficult or showed signs of planning to use these shares as a weapon to obstruct a Hamilton development."

**II.4 The 1963 Proposal**

Despite the political animosity ignited over the Quebec government's plan to nationalize Shawinigan's interest in HFPCo, Brinco was encouraged by a meeting held on January 29, 1963 between Brinco's chairman and chief executive officer H. Greville Smith and Premier Lesage. Premier Lesage informed Greville Smith of his great interest in Hamilton Falls and of his willingness to delay development of the Outardes River if Hamilton power were made available and would be cheaper.[3]

---

[3] This prospect was reinforced in April 1963; in a letter dated April 7, 1964 to Premier Lesage, Robert Winters, Grenville Smith's successor, recalled that "In April 1963 Hydro-Quebec expressed serious interest in obtaining power from the Hamilton Falls and indicated to us that the first generators would have to be in service by 1968."

To inject more vigour into the search for a deal, Brinco appointed Robert Winters of Rio Algom Mines, and already on Brinco's Board of Directors, as its new chairman and chief executive officer in July 1963. Rio Algom itself was a Canadian subsidiary of the Rio Tinto Corporation, a major shareholder in Brinco. Winters was on good terms with both Premier Lesage and Hydro-Quebec's president Jean-Claude Lessard; both Winters and Lesage had been fellow members of parliament, and Lessard had been a senior federal government official at the same time. Winters also had many contacts in Canadian financial and political circles, including Prime Minister Lester Pearson. Additionally, Rio Algom assumed management of Brinco and took a minority ownership interest in HFPCo.

Winters concerned himself with two key tasks. The main task was to work towards a commercial agreement. Hydro-Quebec had already expressed interest and at a meeting held on August 13, Lessard repeated his opinion that there must be an agreement in principle requiring HFPCo to proceed and that it was necessary to be assured of power from Hamilton Falls in 1968 or Hydro-Quebec would have to start planning immediately for alternative sources.[4]

Brinco quickly developed a 22-clause draft proposal. That draft, dated August 16, left open the issue of price, specifying it as simply x mills per kilowatt hour, and it similarly included a clause for recapture, or recall, of some power for Newfoundland use but left the amount open. Still, other key issues were addressed in basic format. In particular, the proposal envisioned a 30-year term beginning in June 1968, the time at which Hydro-Quebec would begin taking power. Also, there was a brief renewal provision, which stated:

> **Both HFPCo and Hydro-Quebec shall have the right to renew the proposed contract for a further term of (25?) years from its expiry date, upon terms and conditions then to be agreed.**

Thus, from the very beginning of what can be considered the first full-fledged negotiations between HFPCo and Hydro-Quebec there was a renewal clause.

Based on meetings with Hydro-Quebec during the remainder of August, Brinco refined

---

[4] See "Notes of conversations on August 13th , 1963 between Premier Lesage, Mr. Lessard and Mr. Winters." These five-page document, dated August 14, 1968 was written by Winters.

its proposal. Brinco officials presented it to Yvon De Guise of Hydro-Quebec at a meeting held on September 3. It was very similar to the August draft. It also left price unspecified. It stated HFPCo would develop the Hamilton Falls site and that energy production would be up to 34 million megawatt hours per year. Most of the electricity, approximately 32 million megawatt hours, would be sold to Hydro-Quebec on a take-or-pay basis. A significant portion of the remainder constituted what would become know as the Twinco block, and which was replacement power for the diversion of water to the new development from a smaller nearby site that had been developed a few years earlier by the Twin Falls Corporation, a subsidiary of HFPCo. Provision was made for possible recall of some of the 32 million megawatt hours for future Newfoundland needs. As for the term of the contract, it would be "approximately 30 years" from the date of the first availability of electrical energy. The renewal clause was slightly clarified and read:

> **Both HFPCo and Hydro-Quebec shall have the right to renew the proposed power contract for a further term of, say, 25 years from its expiry date, upon such terms and conditions as to quantity and price as may then be mutually agreed.**

After receipt of the Brinco draft proposal, Hydro-Quebec prepared a redraft, dated September 5, 1963. The renewal clause was unchanged. On September 6, 1963, De Guise and Morgan-Grenville met to discuss this redraft. At the time, De Guise raised the matter of the term of the contract. According to Morgan-Grenville's notes of this meeting:

> **YdeG said that HQ were now thinking in terms of a 50 year power contract. He did not express this as a firm proposal but rather as a suggestion which might be further considered. He agreed that a contract of that length would require an escalation clause which he thought might specify a price ceiling expressed as a percentage of the original price.**

Over the next few weeks discussions continued and the proposal evolved into a more substantial document, dated October 7, entitled "Basis for Proposed Agreement between Hamilton Falls Power Corporation Limited and the Quebec Hydro Electric Commission." That document kept the wording of the renewal clause in place except that the renewal period was put at 20 years rather than 25 as previously.

In addition to the ongoing discussions, another thing that augured well for an agreement was the prospect that Hamilton Falls power would be less costly than the alternatives. In an internal letter, dated December 2, 1963, to Hydro-Quebec's Jean-Claude Lessard, De Guise reported that the electricity from the best alternative sites would cost approximately 3.1 mills while he put HFPCo at 2.6 mills. This implied that there was room for a deal.

**II.5 Political Reconciliation**

Winters' other key task was to facilitate a reconciliation of the two premiers. On August 13, he met with Premier Lesage and Lessard. They discussed shareholding interests as well as aspects of the potential development. Winters reminded them of Smallwood's reaction to Quebec's nationalization of Shawinigan's HFPCo shares and pointed out the possible conflict of interest if Hydro-Quebec were to be on the Board of HFPCo while negotiating with it for the purchase of electricity. He even offered to buy back the Shawinigan shares at a very attractive price. Lesage responded that his legal and financial experts all advised that Hydro-Quebec retain its interest in HFPCo. Winters outlined other options, such as allowing Newfoundland to be an equity participant. Lesage asked him to formalize his suggestions in writing, which he did. In a letter dated August 14, 1963 Winters repeated his concern about "a serious conflict of interest developing when Hydro-Quebec is party to negotiations for both selling and buying the same power" and he repeated his offer that Brinco would buy back the shares at a price of up to $20 each; Shawinigan having paid $10. His letter also outlined shareholding possibilities that would incorporate Newfoundland participation if Hydro-Quebec were to retain an ownership position in HFPCo.

On October 29, 1963 Winters visited Premier Lesage and their discussions again included the shareholding in HFPCo. Lesage told Winters of a cabinet directive that Hydro-Quebec retain its 20% shareholding position and that it hold that position should any new shares be issued. Winters reminded Lesage that he had, in prior discussions, agreed to move down to a 15% position and he told him that Premier Smallwood was pressing for Hydro-Quebec to go down to 10% and Newfoundland to take up 10%. Lesage agreed to abide by his 15%

commitment but would not agree to any further reduction.[5] In addition, and with Lesage's agreement, Brinco's commitment under its arrangements with Newfoundland to pay an 8% rental on its pre-tax income was extended to all of HFPCo's income, not just Brinco's share of it.[6] In return, Brinco would compensate Hydro-Quebec by transferring some additional HFPCo shares to Hydro-Quebec; similar compensation would be given to Rio Algom. Fortunately for Winters, these arrangements were sufficient to satisfy both premiers. By the end of 1963 all had been agreed. The ownership structure of CFLCo would be:[7]

| | |
|---|---|
| Brinco | 68.3%; |
| Hydro-Quebec | 16.3%; |
| Rio-Algom | 10.4%; |
| Newfoundland | 5.0%; |

and, despite Winters' concerns over conflict of interest, Hydro-Quebec got its seat on the CFLCo Board; Jean-Claude Lessard took the position on January 22, 1964.

Thus by the end of 1963 substantial progress had been made. The ownership positions in HFPCo had been resolved and commercial talks were well underway. HFPCo itself was making expenditure commitments for 1964, in anticipation of an agreement in the near future, to accommodate Hydro Quebec's anticipated need for power by 1968.

---

[5] According to Winter's record of the meeting, the discussions also dealt with other matters such as price, which Winters indicated he was hopeful of delivering it to Hydro-Quebec at about 3 mills. Lesage also pointed out that a decision between Hamilton Falls or the Outardes in Quebec would have to made soon. Winters responded that they were proceeding as if the agreement were in place, with engineering plans and specifications being developed. Other issues included possible arrangements with Consolidated Edison and, ominously, the boundary.

[6] See letter from Winters to Lesage dated December 3, 1963 regarding this rental arrangement.

[7] Although, this allocation would not be realized until Rio Algom took up its option to buy shares allocated to it. According to Brinco's Annual Report for 1966 (p.8) Rio Algom did so in February 1967.

## II. 6. Negotiations Break Down

As talks continued into 1964 more drafts of the "Basis" document were prepared. All were similar in format and all retained a renewal clause based on the notion of future mutual agreement. The March 30, 1964 draft's renewal clause, which was unchanged from the October draft, was:

> **Both HFPCo and Hydro-Quebec shall have the right to renew the proposed power contract for a further term of, say, 20 years from its expiry date, upon such term and conditions as to quantity and price as may then be mutually agreed.**

The March 30th draft also provided for a 35-year term rather than 30 as in the original proposal and the October 7th one, and it envisaged first power in 1969. It continued to recognize that Hydro-Quebec anticipated that it would re-sell some of the power to Consolidated Edison. As for price, it indicated 2.4 mills for the bulk of the power. To facilitate financing it also contained a provision under which Hydro-Quebec's payments would not be less than the amount needed by HFPCo to service its debt.

By this time, however, price became a major stumbling block. In a letter to Robert Winters dated April 10, 1964, Hydro-Quebec's Lessard suggested a price of 2.0 mills. Lessard offered that Hydro-Quebec could provide a loan to HFPCo and buy more shares in HFPCo if this offer adversely affected HFPCo's financing arrangements. This was unacceptable to HFPCo. Winters pointed out, in a response letter dated April 13, that all his previous suggestions regarding price were in the area of 3 mills.

In May a committee was struck by Hydro-Quebec to consider the issues and negotiate with HFPCo officials and their financial advisors. In its report, submitted June 8, 1964, that committee confirmed its preference for public ownership by a joint Quebec-Newfoundland government corporation.[8] The committee noted that the shareholders did not want to sell and also acknowledged Quebec's inability to expropriate the shares of the company since it was

---

[8] This group had previously been established and had submitted a report on February 11, 1964 that had explored the possibility of converting HFPCo into a public corporation to be owned by Newfoundland and Quebec.

federally incorporated with its head office in Newfoundland, nor expropriate its assets, which were also in Newfoundland. Abandoning that tact, the committee's approach reflected a philosophy that power from Hamilton Falls should be priced, not only below the cost of alternative power to Quebec, but such that profit should not exceed that of a publicly regulated private utility. The committee's estimate of cost was lower than HFPCo's and the committee viewed 6.5% on "rate base", i.e., on the capital investment, as the appropriate rate of return. The committee recognized that Brinco had compensated Hydro-Quebec as a shareholder for the Newfoundland 8% rental but argued that there should also be compensation to Quebec as a purchaser of electricity since the price would embody the rental. Hence, they argued that Hydro-Quebec should have more shares in HFPCo at a low price.[9] The committee concluded that a price of 2.4 mills was appropriate. Among other things it also recommended were: that Hydro-Quebec negotiate to increase its holdings in HFPCo to 25% buying those additional shares at only $10; that there be more Hydro-Quebec representation on the HFPCo Board of Directors; that the contract term be 35 years from first power; that the contract require HFPCo to maintain an office in Quebec so HFPCo would be liable for its provincial corporate income tax; and that any agreement ensure maximum Quebec benefits from the construction of the project. The committee's report did not touch on the topic of renewal.

On June 29, Winters met with Premier Lesage. Winters' record of the meeting indicates that the conditions put forward were too onerous. He also pointed out that at 2.65 mills or less the retained earnings over the life of the contract would show deficits. Lesage suggested that the Quebec government might be able to assist by undertaking to guarantee any cost over-run. With further discussion, and the advice of HFPCo's financial advisor William Mulholland, of Morgan Stanley, who joined the meeting, some compromise options were explored. They were: HFPCo studying how much they could lower the price in return for Quebec government guaranteeing cost-overruns; allowing Hydro-Quebec ownership to increase to 20% but with Newfoundland being offered a proportionate increase in ownership and at $30 a share for both provinces. In addition to Lesage's offer that Quebec guarantee any borrowings needed to finance an over-run,

[9] In effect, its position was that all potential gains, as represented by the cost advantage over alternatives available to Hydro-Quebec, should go to the purchaser of the power and none to either the developer, HFPCo, or the resource-owner, Newfoundland.

Winters also sought more undertakings: a price escalation scheme that allowed the price to change with project cost; an adjustment in price if the rate of return went below 6.5%; and Quebec guarantees for HFPCo bank loans taken between the signing of a letter of intent and the signing of a definitive power contract. The meeting ended with Lesage indicating that a decision might be made at a cabinet meeting scheduled for July 8. Again, renewal was not a matter of debate.

This sort of quid-pro-quo arrangement, namely a low-price regime in return for undertakings to protect HFPCo from losses and to ensure that HFPCo would be able to raise sufficient funds to complete the project, would turn out to be a key characteristic of a Letter of Intent. That Letter of Intent would, however, take some time to reach.

On July 8, in the Quebec Legislature, Premier Lesage announced that it was impossible to arrive at an agreement at the time. Following this breakdown, HFPCo considered the options of either transmitting power through Quebec or via the so-called Anglo-Saxon route. Smallwood was in favour of the latter. That route involved transmission of electricity from Churchill Falls to the south coast of Labrador, connecting to the island of Newfoundland by subsea cables and continuing from there with more subsea cable links to Nova Scotia for integration with the Maritimes and New England electrical grids. HFPCo concluded that this was uneconomic; the US price was likely to be about 5 mills but the cost of transmission through this lengthier route plus the cost of energy generation were very likely to exceed that amount.[10] As for passing through Quebec, Premier Lesage made it clear that he would never agree to it.[11]

**II.7 A New Start**

By early 1965, Winters was still considering his options, and Hydro-Quebec and HFPCo were still in contact with one another. At this stage, it also appears that Winters had accepted that the scope for profit would be limited; he wrote Premier Smallwood on January 5 and pointed

[10] See "Review of pertinent considerations on alternatives for the development of Hamilton Falls Power," dated January 21, 1965, and prepared by Donald McParland.

[11] See "Memorandum of a Meeting between Premier Lesage and Messrs Bourget and Monast at the Prime Minister's Office, on Thursday, 27th of August, 1964."

out that selling power to Hydro-Quebec "at 2.75 mills, the return to HFPCo and hence to the Brinco shareholders is not too exciting a prospect." In a letter to Smallwood, dated February 3, 1965, he raised the possibility of having the federal government eliminate its corporation tax on privately owned electricity generators and also indicated that he would be exploring the possibility of taking the power through Quebec rather than selling it there.

Regarding a return to formal negotiations on a sale agreement to Hydro-Quebec, on April 24, Winters and Lesage met to review their positions. According to his record of this meeting, Winters reminded Lesage of his previous price offer and the Quebec undertakings on which that offer was based. Also, ways to mitigate HFPCo's price were discussed, namely: elimination of federal corporate tax and Newfoundland provincial taxes, the use of direct-current transmission, and a longer repayment period for bonds, which had been put at 25 years.[12] They also discussed rapprochement with Smallwood.[13]

A May 1, 1965 letter to Hydro-Quebec from Winters re-ignited the negotiations. It contained two proposals. If Hydro-Quebec did not want to purchase the power, Proposal "A" entailed the construction of a DC transmission line across Quebec to markets elsewhere in Canada and in the United States. Alternatively, Proposal "B" offered a sale agreement to Hydro-Quebec. If the previously discussed undertakings were still available, then he proposed a 40-year contract at an average price of 2.55 mills and committed to pass along any savings arising from any change in federal corporate income tax. Winters also wrote that, as they had previously discussed, he envisaged a formula to adjust the price in relation to actual final cost. More elaboration followed in another letter from Winters, dated May 11, which indicated that, under a sale agreement with Hydro-Quebec, the price could go as low as 2.3 mills. Before the end of the month, Hydro-Quebec and HFPCo were working on a draft Letter of Intent.

At the same time Winters continued his efforts to reconcile the two premiers. This was not easy. Lesage had made public statements that Quebec government approval of an agreement

---

[12] See letter from Winters to Smallwood, dated January 18, 1965 which included a tabulation of returns to Newfoundland. The figures were based on the bonds being repaid over 25 years.

[13] Winters had even engaged Prime Minister Lester Pearson in his efforts to secure a deal and to bring the two premiers into harmony; he wrote Pearson a letter dated April 28 in this regard

between HFPCo and Hydro-Quebec would be dependent on a change in the boundary. This angered Smallwood as did the shift in negotiations away from Proposal A to Proposal B. Smallwood wrote a scathing letter, dated May 15, to Winters to express his anger on both points. In subsequent conversations Winter attempted to allay Smallwood's concerns. He also wrote a conciliatory letter, dated May 19, in which he suggested that if Smallwood were to agree to giving access to Hydro-Quebec to headwaters of certain rivers in southern Labrador but which flowed into Quebec, it would obviate any need for attempting any change in the boundary. Winters' letter also stated that he had told Premier Lesage that any matter related to the border would have to be dealt with directly between the two premiers and was beyond his scope. The letter then assured Smallwood that he would not ask him to agree to anything that was unfair and unreasonable, that he was convinced an agreement could be reached with Hydro-Quebec and that the development depended to a great degree on Smallwood and Lesage soon reaching a "measure of mutuality." These reassurances seem to cool the political sensitivities as negotiations continued.

On June 7, Premier Smallwood wrote the Prime Minister confirming that an understanding had been reached among Newfoundland, Quebec, HFPCo and Hydro-Quebec regarding development of the Churchill Falls. His letter requested that, in order to allow the project to proceed without delay, the federal government eliminate the federal corporation tax on private producers and distributors of electricity. To meet this request, in July the federal government announced that rather than 50% of federal corporate tax from utilities being rebated to provincial governments, the Public Utilities Income Tax Transfer Act (PUITTA) would be amended so that 95% would be returned. Newfoundland could then, as agreed, turn over half of this to HFPCo, which would in turn pass this on to Hydro-Quebec through the price.

On June 8, 1965 Hydro-Quebec sent a draft Letter of Intent, dated May 31, to Brinco. This draft, which anticipated first power in 1970, was quite similar to the "Basis" documents that had been discussed in late 1963 and early 1964. However, it did incorporate a much longer term, namely 44 years from first power, rather than the 30 or 35 years of previous discussions and 4 years more than Winter's most recent concessionary offer of 40 years. However, the document also reflected some of the undertakings that Winters had sought, namely, an adjustment in price if capital costs turned out to differ significantly from a specified estimate, and a provision for

Hydro-Quebec to provide loan guarantees if the capital cost exceeded the estimate. There was also a renewal clause, which stated:

> **Hydro-Quebec shall have the right to renew the proposed power contract for a further term of years from its expiry date, upon such terms and conditions as to quantity and price as may then be mutually agreed. It will also be given right of first refusal prior to any contract that HFPCo may then be willing to sign with a third party other than Newfoundland.**

The significant addition to the renewal clause was Hydro-Quebec's right of first refusal but, crucially, the clause retained the commitment for future negotiations on mutually agreeable quantities and prices. Nevertheless, this provision was now substantially weakened indirectly. The extension of the contract's term to 44 years from the availability of first power was significantly longer than the 30-35 years contemplated in earlier negotiations. Renewal was thus pushed much further into the future.

### II.8 Agreement

Work on the Letter of Intent continued over the summer. At the July 29, 1965 meeting of the HFPCo Board of Directors, Winters reported that substantial agreement had been reached on all major points of principle. In reviewing the latest draft of the Letter, dated July 12 and which now called for power by March 1971, he listed 14 points that remained to be negotiated but indicated that the parties were close to agreement. None of the 14 points involved renewal.

Despite the momentum of the negotiations during the summer of 1965, another year of negotiations passed before there was an agreement on the Letter of Intent. There appears to have been no major disagreements and several drafts of the Letter of Intent were discussed throughout the process. Technical studies by Hydro-Quebec into October of 1966 and the resignation of Winters in December of 1965 to re-enter federal politics were among the possible explanations for the delays. Henry Borden, who had been Chairman of the Board of Brinco, succeeded Winters as president and chief executive officer of Brinco, while Donald McParland took the presidency of HFPCo itself. It was also in 1965 that the Hamilton River was, on Smallwood's initiative, renamed the Churchill, and consequently HFPCo adopted its new name CFLCo.

On June 6, 1966 Hydro-Quebec commissioners approved an agreed Letter of Intent

subject to approval of the government of Quebec. However, in the same month, the Union Nationale defeated Lesage's Liberals in a provincial election. On July 6, Lessard wrote to the new premier, Daniel Johnson, asking for Cabinet approval for this Letter of Intent. On July 22, he wrote to Johnson again, this time pointing out the advantages of the Letter of Intent: it would allow Hydro-Quebec to reduce its capital borrowing requirements, it provided Hydro-Quebec with a lower cost of energy than the available alternatives in Quebec including nuclear energy; and the Churchill Falls development would make extensive use of Quebec manpower. Lessard's letter ends with a recommendation that the Letter be signed as soon as possible. Nevertheless, the new premier decided to re-examine the document and further negotiations followed.

The additional delay added to Smallwood's impatience with the slow progress, and he obtained cabinet approval to approach the federal government to request that the project be designated in the national interest so that, failing an agreement, the federal government would support a power corridor through Quebec.

By September a new draft Letter of Intent had been formulated. Robert Boyd, then Hydro-Quebec's general manager, in a letter dated Sept 22, 1966 to Hydro-Quebec's commissioners, strongly endorsed the modified Letter of Intent. He highlighted several points of advantage, notably the cost being lower than any other source that Hydro-Quebec could undertake including nuclear energy. Boyd's letter, which likened the deal to a "life raft" for Hydro-Quebec, concluded "I must insist on these points, which I consider to be of the utmost importance for the good of Hydro-Québec and the province." On October 3, Hydro-Quebec then approved the revised Letter and recommended it to Premier Johnson. On October 6, it received government approval and on October 13, Donald McParland and C. T. Manning for CFLCo and Jean-Claude Lessard and Jean-Paul Gignac for Hydro-Quebec signed the agreement.

Also, Quebec's Premier Johnson announced the establishment of a commission to study and report on the boundary question, effectively decoupling it from the power contract talks.[14] And on the Newfoundland side, in light of the agreement, Smallwood did not request federal government intervention.

[14] The commission's report concluded that there was no judicial basis for challenging the boundary; see Dorion (1971, Vol. 3, 3.2, p.12).

The agreed Letter of Intent now put the term at either 44 years from first power or 40 years from completion of the last generating unit, whichever was longer. As for the renewal clause, it now read:

> **Hydro-Quebec shall have the right to renew the definitive power contract for a further term of years from its expiry date, upon such terms and conditions as to quantity and price as may then be mutually agreed. It will also be given the right of first refusal prior to any contract that CFLCo may then be willing to sign with a third party for power consumption within Quebec.**

This wording was consistent with all the prior drafts, including the one that Hydro-Quebec had already endorsed in June.

The Letter of Intent represented a compromise of sorts between the approaches of the two negotiating parties and reflected the basic quid pro quo marking the discussions between Winters and Lesage in April and May of 1965. On the one side, Hydro-Quebec would be obtaining a very large amount of power, approximately 32 million megawatt hours annually, at a very low price, approximately 2.6 mills during construction and falling at stages until it was slightly less than 2.3 mills for the last 15 years of the term of the contract. These prices were tied to the capital cost so if the facility cost less than anticipated in the agreement, then the savings would be passed on to Hydro-Quebec through a downward adjustment in price. Thus, the pricing was consistent with the philosophy of Lesage's advisory committee of 1964 that profitability be limited along the lines of publicly related private utilities. On the other hand, CFLCo did receive elements of the undertakings that had been discussed in 1965, and which were intended to protect it from losing money or failing to raise sufficient funds to complete the project, given this price regime. It did not receive the guarantee of a price increase if its rate of return fell below 6.5% but there were adjustments by which the price would change if the capital cost turned out to be higher than estimated or if the interest costs for the project were higher than then contemplated. The exchange rate risk - most of the financing would be borrowed in the US - would be shared. Also there was an undertaking that Hydro-Quebec would either guarantee, or provide, a loan up to $109 million if there was a capital cost over-run and CFLCo could not otherwise obtain the necessary funds to complete the project. A similar provision had been in the June draft but had included both the Quebec government and Hydro-Quebec. Now it would be

solely the latter. A condition was added that gave Hydro-Quebec the right to veto any CFLCo dividends if this assistance was ever triggered; this arrangement as it evolved would eventually be known as the completion guarantee.

The Letter retained the basic "take-or-payment" provision and the associated commitment by Hydro-Quebec to make monthly minimum payments sufficient to cover debt service and fixed costs. Another provision, which had been added to the new Letter as a result of Johnson's re-examination, gave Hydro-Quebec the right to complete the project, and obligated CFLCo to cooperate in this, should it become apparent that CFLCo would not be able to complete it itself. When the CFLCo Board met on September 30 to consider this and the other changes to the Letter, it was recognised that this right-to-complete would not give Hydro-Quebec the right to take over the asset and that rather than being detrimental to CFLCo, might even be beneficial to it.

In short, the quid pro quo was a long-term low-price regime in exchange for price adjustments and other assistance if changes in key parameters substantially reduced the return or caused losses. And both parties were recognizing their mutual interest in ensuring that the project be completed.

## III. CONTRACT NEGOTIATIONS

With the comprehensiveness of the Letter of Intent, it might have seemed that the translation of it into a definitive power contract would have been a straightforward task. CFLCo initially appeared to believe that to be the case but, as this section describes it, the path to the final contract was lengthy.

### III. 1. Early Stages

Following the signing of the Letter of Intent on October 13, CFLCo immediately went into action. According to its Annual Report (p.6) for 1966, within thirty days construction crews had returned to the site and were at work. Even before the end of October, legal advisors to CFLCo had prepared an outline of the proposed power contract. That outline was a comprehensive document based on the Letter of Intent. It discussed the likely contents of each clause and, at times, suggested wording and/or who to consult. As far as the renewal clause was

concerned, the only difference was the insertion of a suggestion that a one-year notice be given by Hydro-Quebec should it decide to renew.

By March 1967 CFLCo envisaged a schedule that would lead to a power contract by October 31 of that year.[15] For CFLCo the key negotiators were its president and CEO, Donald McParland who had succeeded Winters, Eric Lambert, vice-president-finance, C.T. Manning, vice-president(legal) as well as John Tennant, a lawyer with the Montreal law firm of Cate, Ogilvy, Bishop, Cope, Porteous & Hansard. Key players for Hydro-Quebec were Boyd, De Guise, and Lessard, long-time members of senior management, and André Gadbois, of the law firm of Archambault and Boulanger. Jean Paul Cardinal and Marcel Lajeunesse, of the law firm of Bumbray, Carroll, Cardinal, Lajeunesse and Dansereau, also played an important part in the negotiations as representatives of the government of Quebec. There was no representative of the Newfoundland government in the negotiations. The first negotiating meeting was held on March 22 and meetings continued throughout the year.

### III.2 Brinco's Financial Challenges

To meet Hydro-Quebec's requirement for first power, which was now 1972, CFLCo had undertaken a substantial expenditure program for 1967. The slow pace of negotiations was such that CFLCo now was anticipating that reaching an agreement on a definite power contract would take longer than initially expected. Therefore major financing for the project would not be in place until June 1968; the success of the financing plan depended on an agreement on a definitive contract. CFLCo would have to find enough new funds to last until then. According to Smith (1975, p.266) by April, its financial advisor, William Mulholland of Morgan Stanley, expressed concern over the pace of spending and suggested that either spending commitments be curtailed or funds be raised by means other than more bank loans.

By June 1967, a document entitled "Interim Financing: The Problems and a Suggested Solution" had been developed by CFLCo's Eric Lambert. It recorded that as of March 31, 1967, CFLCo had already spent $20.5 million on the project, which was then anticipated to cost between $750 and $800 million. CFLCo had a $10 million line of credit with the Bank of

[15] See John Tennant's "Memorandum of CFLCo Meeting of March 10, 1967."

Montreal to cover anticipated expenditures from April to June 1967. To cover July 1967 to June 1968, it needed an additional $45 million. It was determined that the only feasible option was to raise $37.5 million in a new share issue in CFLCo, which would be sold in September. A $5 million extension of the line of credit with the Bank of Montreal would be sought to cover expenditures until that month. Lambert's document anticipated that the $37.5 million would then provide CFLCo with enough funds to repay the Bank and cover its requirements until January or February 1968, after which time interim bank financing could be relied upon until June. It was also envisaged that Brinco would not purchase any of these new shares. Its financial situation was tight and it needed funds for other commitments. Therefore, the plan was that new CFLCo shares be sold through a public offering. Assuming that the other three shareholders held their relative positions, Brinco's ownership in CFLCo therefore would fall to approximately 40%. Thereafter it would maintain that position when a second issue of shares, planned as part of the overall financing package, was forthcoming in June.

On September 15, 1967, shareholders of Brinco were advised of the planned public share issue of CFLCo itself. The issue was abruptly cancelled in October. According to a letter issued to its shareholders on October 31, 1967, Brinco informed them that despite the September 15th advisement "Owing to market conditions, which could not then be foreseen, CFLCo will not proceed with the public issue."

To save the situation, Brinco had to hurriedly seek the cooperation of the other three shareholders to subscribe for these shares on a pro-rata basis. This meant that Brinco, reflecting its 68.2% stake in CFLCo at the time, would have to take approximately $25.5 million of $37.5 million. To do so it had to obtain a $21 million line of credit with the Bank of Montreal for which it had to pledge its shares in CFLCo and in Brinex, its mining subsidiary. Even then, it could not maintain its position. It sold some of its CFLCo shares to the Newfoundland government for $4.6 million.[16] As a result of these and related transactions, the ownership

---

[16] This also satisfied Smallwood's objective that Hydro-Quebec not increase its position in CFLCo relative to Newfoundland's.

interests became:[17]

| | |
|---|---|
| Brinco | 63.3%; |
| Hydro-Quebec | 16.3%; |
| Rio Algom | 10.4%; |
| Newfoundland | 10.0%. |

Not only did its ownership position decline but, entirely contrary to plan, Brinco was now saddled with an additional $21 million in bank debt. As a result, its financial position became such that in the following months Donald Gordon, its president and chief executive officer, approached one of its shareholders, Rio Tinto-Zinc, for rescue; see Schull (1979, p.260). Brinco was a widely held company, publicly traded on the stock market. Rio Tinto-Zinc's ownership of 6% of its shares likely made it the largest single shareholder. Remarkably, Hydro-Quebec owned a 2% interest in Brinco; thus giving it a further indirect interest in CFLCo.[18]

Over the coming months of 1968, while negotiations between CFLCo and Hydro-Quebec edged forward, there were parallel complex and confidential financial discussions undertaken by Brinco, Rio Tinto-Zinc and potential investors aimed at addressing Brinco's precarious finances.

**III.3 Negotiations Continue**

Despite its much weakened financial situation, by the end of October 1967, Brinco did have good reasons to be optimistic about CFLCo's prospects. By this time it was apparent that Hydro-Quebec would need all the power from Churchill Falls so a re-sale agreement with Consolidated Edison or other third parties was no longer required. With the October share issue, sufficient funds had been injected to cover anticipated spending until the early months of 1968. Also, given Hydro-Quebec's desire for new power by 1972, there was less time available to switch to alternative sources. More so, Hydro-Quebec's willingness to participate in the share issue would have been an indication of a preference for Churchill Falls power over the alternatives.

---

[17] See the Brinco Annual Report 1967, p.4 and p.10 and "Churchill Falls (Labrador) Corporation Limited: Equity Financing and Advances" October 20, 1967.

[18] See "Interim Financing: The Problems and a Suggested Solution," June 3, 1967, p.9.

Also, progress had been made on the contract and, despite the slow pace, no severe difficulties had arisen. By early July, a Power Contract Format had been exchanged between the two parties. Following a request from Hydro-Quebec in August, it was agreed that an 11th generating unit would be installed. The resulting estimated additional cost was put at $28 million at the time, which would of course increase funds required in the major financing arrangements. On the renewal clause, both sides agreed that a longer notice period of at least five years was desirable. This was not a contentious issue; for Hydro-Quebec it would allow time to find an alternate source of power if there was no renewal and in CFLCo's case it would give more time to find an alternative market.[19]

By early September of 1967, CFLCo deemed it necessary to have a final agreement in the near future and set October 15 as the target date for completion.[20] A first draft contract, dated September 19, had been exchanged. That was followed by an October 6th draft. As had been the case since the 1963 proposal, both contained a renewal clause. That renewal clause remained consistent with the original meaning of the 1963 proposal as well as the 1966 Letter of Intent and all the discussions to date. The version in the October 6 draft was as follows:

> **Hydro-Quebec shall have the right to renew this Power Contract for such further term and upon such terms and conditions as to quantity and price as the parties may agree. Should Hydro-Quebec wish to renew this Power Contract, it shall notify CFLCo in writing at least 10 years prior to the expiry of the term hereof of its willingness to renew and the parties shall thereupon negotiate and agree upon the term of such renewal as well as upon the terms and conditions as to quantity and price applicable for such renewal. If the parties agree on a further term of years as well as on the terms and conditions as to quantity and price applicable to renewal, such agreement shall be evidenced by a notice given by one party and accepted by the other, setting out the further term and the terms and conditions as to quantity and price mutually agreed upon and the receipt by one party of such notice duly accepted by the other shall automatically renew the Power Contract for the further term and upon such terms and conditions as to quantity and price as determined in the said accepted notice.**

---

[19] C.T. Manning's Record of meeting of Power Contract drafting committee of May 2, 1967, p.2.

[20] See "Minutes of a Meeting held in the Board Room on September 5, 1967," dated September 7, 1967.

**Should Hydro-Quebec fail to give notice of its willingness to renew within the delay specified in the preceding paragraph or, Hydro-Quebec having given such notice, should the parties fail to agree at least 8 years prior to the expiry of the term hereof, on the further term or on the terms and conditions as to quantity and price which would be applicable to the renewal, CFLCo hereby undertakes and agrees that if it should, at any time during the said period of eight (8) years prior to the expiry of the term hereof and during a further period of six (6) months following the said expiry, receive any "bona fide" offer from a third party for the purchase for consumption by the offeror in the Province of Quebec of energy from the Plant, which CFLCo is willing to accept, CFLCo shall, within a period of 90 days from the receipt of said offer, give written notice to Hydro-Quebec of the amount of energy, price and principal terms and conditions contemplated by said offer, and enclose with such notice a copy of said offer, and Hydro-Quebec shall have the right, by giving written notice to CFLCo within a period of 90 days from the receipt of CFLCo's said notice, to purchase the amount of energy contemplated by said offer at the price and upon the terms and conditions therein contained. In the event that Hydro-Quebec shall not exercise such right, CFLCo may within but not after a period of 90 days from the earlier of Hydro-Quebec notifying CFLCo that Hydro-Quebec does not propose to exercise such right or the date of termination of the delay for the exercise of such right, sell to the party making such "bona fide" offer the amount of energy contemplated thereby for the price and upon the terms and conditions therein provided. This right of first refusal in favour of Hydro-Quebec shall apply to each and every such offer for energy from the Plant for consumption by the offeror in the Province of Quebec received by CFLCo within the aforesaid period of 8 years prior to and 6 months following the expiry date of this Power Contract and shall survive the said expiry date.**

Thus, the renewal clause had been substantially fleshed out compared to earlier versions but the substance was not changed. The most notable addition was the specification of time periods for notifications and for negotiations.

By late October, CFLCo considered time to be of the essence and was then aiming to have the contract "completed by November 30, 1967 subject only to lenders' requirements."[21] More drafts followed, including ones dated October 27, November 3 and November 13. Despite CFLCo's November 30th target, negotiations continued. However, in an internal memorandum

[21] See Eric Lambert's "Notes for Meeting to be held Tuesday, October 24, 1967" dated October 23, 1967.

dated December 5, 1967, CFLCo's McParland wrote "Progress to date suggests that the Power Contract is moving into its final stages."

During the next month, negotiations continued and more drafts were prepared, including ones dated December 5, December 21 and December 31. In early January of 1968 it was agreed at internal CFLCo meetings that "all efforts should be directed towards achieving a high measure of agreement on the power contract by 31 January."[22] The strategy would be for CFLCo to work in consultation with its legal and financial advisors in order to, as E. Lambert wrote in an internal memo on January 5, 1968, "to arrive at a Power Contract acceptable to CFLCo from technical, commercial and financial standpoints and then to re-open detailed discussions with Hydro-Quebec on it." It appeared that the version of the contract that CFLCo was preparing would also largely be acceptable to Hydro-Quebec. An agenda prepared by CFLCo's Finance Department for a January 12 meeting noted that "Using February 1, 1968, as a commencement date, a timetable should be drawn up for the completion of the Bond Offering Memorandum, and the finalization of its support material." In part, CFLCo's urgency also reflected its financial situation. It had anticipated that the 1967 October share issue would provide enough funds until the early months of 1968.

CFLCo's efforts produced a draft dated January 15$^{th}$, 1968. Consistent with earlier versions, it contained numerous clarifications and there were editing changes but the substance was intact. The renewal clause also remained but, following a practice that started with the December 21 draft, it was divided into two sections, one devoted to renewal itself and the other to first-refusal. The renewal section was little changed. It now read:

> **Hydro-Quebec shall be entitled to renew this Power Contract for such further term and upon such terms and conditions as to quantity and price as the parties may agree. Should Hydro-Quebec wish to renew this Power Contract it shall notify CFLCo in writing at least 10 years prior to the expiry of the term hereof of its willingness to renew. The parties shall thereupon negotiate the term of such renewal and the terms and conditions as to quantity and price applicable to such renewal, including provisions, if any, for further renewal. If the parties are able to agree to renewal at least eight**

[22] See "CTM's record of meetings relating to the Power Contract 3 and 4 January 1968." CTM refers to C. T. Manning.

**years prior to the expiry of the term hereof, a renewal agreement shall thereupon be executed between them. If the parties fail to agree upon renewal within the aforesaid time limit, Hydro-Quebec's right to renew shall thereupon lapse. Should Hydro-Quebec and CFLCo have terminated negotiations for renewal of this Power Contract at any time after the giving of the notice aforesaid and prior to that date which is eight years earlier than the expiry of the term hereof, Hydro-Quebec's right to renew shall lapse upon cessation of negotiations.**

This renewal section was followed by the first-refusal section, which reflected the essence of the earlier provisions in that regard.

Two other important articles of the January 15th draft deserve mention because of their relevance to subsequent developments. One was the article entitled "Completion Guarantee." It had it origins with the Quebec undertaking to guarantee or provide loans to CFLCo if the final cost of the project exceeded an agreed estimate. Its lineage may be traced back to the offer by Premier Lesage to Winters at their June 29, 1965 meeting; and it was embodied in Clause 25 of the Letter of Intent, which assigned the commitment to Hydro-Quebec, rather than the Quebec government.[23] Such loans or loan guarantees, if ever needed, would now be conditional on CFLCo having first raised a minimum of $700 million in financing, rather than being conditional on the cost exceeding $700 million as had been previously used as the benchmark.

The second important article of note was also a financial one. This article was entitled "Debt Service Requirement and Expense Charges." Its origins can be traced back to the take-or-pay provisions as discussed late in 1963 and early 1964; see, for example, Annex A to the Draft Basis for Proposed Agreement between HFPCo and Hydro-Quebec, dated January 7, 1964. It was also reflected in Clause 24.0 of the Letter of Intent, as well as clause 5D of the draft of October 6. It had now evolved to the point where if payments made to CFLCo, on a take-or-pay basis, were not sufficient to cover its debt service and expense charges then Hydro-Quebec would provide advances to cover the gap.

---

[23] This Completion Guarantee article first appeared in the December 21st draft. At earlier stages of the negotiations, it had been intended that this guarantee not be embodied in the contract but dealt with separately; see Annotation to the October 6, 1967 draft contract.

### III. 4 Hydro-Quebec's Draft of February 18, 1968

Following the January 15 draft, negotiations continued into February and an agreement appeared near. In a note, dated February 12, 1968, CFLCo's John Tennant summarized the points that had been raised by Hydro-Quebec as well as Morgan Stanley that still needed to be addressed. Tennant's notes did not suggest any of the matters involved sharp disagreements or required substantial changes to the draft.

Also, when the CFLCo Board met on February 13 indications were that the draft contract was close to its final form. According to the minutes of that meeting, McParland reported

> **A draft contract had been delivered to Hydro-Quebec and counsel for the Government at the end of December, followed on January 15th by a draft representing more fully the conditions relative to financing as presently foreseen by the Company's local and U.S. financial advisors. It was hoped that discussion with Government representatives on this last draft would take place shortly and that a mutually satisfactory contract could be submitted for Board Approval in the near future.**

Hydro-Quebec's Jean-Claude Lessard attended this meeting in his capacity as a CFLCo Board member. There is nothing in the minutes of the meeting to indicate any disagreement from him regarding McParland's optimistic predictions. Although, he did inquire whether the January 15th draft represented CFLCo's maximum conditions. Later in the same meeting, the Board was informed that its cash position would be $14 million at the end of February, that accounts payable were running at $5 million monthly, and that available funds would last until the end of May. Neither this impending shortage of funds nor the fact that Mr. Lessard was being made aware of it appeared to raise any concerns. The minutes of the meeting indicate that the expectation was that with satisfactory progress on the contract bridge funding from banks would be readily available.

On February 14, the day after the Board meeting, talks with Hydro-Quebec took place. Some additional points were raised.[24] None was particularly difficult. Also at that meeting Hydro-Quebec informed CFLCo that it had not yet come to grips with the financial definitions

---

[24] See Memorandum: Draft Power Contract discussions - Points raised by Hydro-Quebec at February 14 discussions.

and clauses and that it was preparing its own draft of the contract which it would submit to CFLCo. That Hydro-Quebec draft, dated February 18, 1968, was submitted to CFLCo under a covering letter from Robert Boyd dated February 23. Several issues remained to be resolved and an entirely new and substantial element was included. This draft provided that new shares in CFLCo be attached to any loans advanced to CFLCo by Hydro-Quebec under the Completion Guarantee article (Article V of this draft). If the article were ever triggered, Hydro-Quebec, under this draft's proposed section 5.4, would receive debentures that were convertible into shares and, if the total amount advanced was more than $110 million, would also receive bonus common shares in CFLCo at a rate of 1 per $500 advanced. The previously agreed quid pro quo had been a low-price regime in exchange for assurances of such advances if they were needed, which would be repaid with interest. Now, Hydro-Quebec was proposing to change the arrangement so that it would obtain a larger ownership position. Also, this draft proposed a lower price for electricity made available during the period between first power becoming available and the completion of the project.

Still, in Hydro-Quebec's February redraft the wording of the renewal provision was little changed from CFLCo's January draft, and the substance remained as it had been since the proposal of September 1963. The renewal section was now:

> **Hydro-Quebec shall be entitled to renew this Power Contract for such further term and upon such terms and conditions as to quantity and price as the parties may agree. Should Hydro-Quebec wish to renew this Power Contract it shall notify CFLCo in writing at least 10 years prior to the expiry of the term hereof of its willingness to renew. The parties shall thereupon negotiate the term of such renewal and the terms and condition as to quantity and price applicable to such renewal, including provisions, if any, for further renewal. If the parties are able to agree to renewal at least eight years prior to the expiry of the term hereof, a renewal agreement shall thereupon be executed between them. If the parties fail to agree upon renewal within the aforesaid time limit, Hydro-Quebec's right to renew shall thereupon lapse.**

### III. 5. A Price Formula for the Renewal Period

The first evidence of any possibility of a substantial change came on Monday, February 26, 1968. That evidence is two pages of handwritten notes from CFLCo's files, which are

reproduced in Appendix I. These two pages were in C.T. Manning's writing and his initials appear at the top right-hand corner of the first page and the date of 26-2.68 appears on the top left-hand corner of the same page. They record a working-through of the issues associated with specifying a fixed price during the renewal period. They do not appear to be from a meeting because other hand-written notes by him typically list the names of those in attendance, and there are no references to other persons.

The notes start by identifying the problem, namely how could the contract be extended for an additional 10 to 25 years at a fixed mill rate. It indicates that this would act to avoid criticism from proponents of nuclear power.

Next, his notes turn to the Water Power Lease, i.e., the lease from Newfoundland under which CFLCo had access to Churchill Falls watershed. The legislation governing the lease permitted the Newfoundland government to remit half the PUITTA rebate to CFLCo for the term of the contract, which the legislation anticipated to be approximately 40 years. That legislation explicitly excluded the rebate continuing for any renewal period. His notes indicate that without an amendment to the Lease legislation then the tax benefit of the PUITTA rebate would probably be lost.

On the top of the second page of his notes, Manning concludes that granting Hydro-Quebec an option to extend the term of the contract may be "the right out" provided that the price is on a formula basis. That formula would have to build in compensation to CFLCo for the loss of the PUITTA rebate and for covering replacement cost of plant and equipment, and to avoid prejudicing an agreed return on equity.

In the remaining notes, Manning turns to the issue of how to change the Power Contract's provisions to incorporate a fixed price for the renewal period. The notes indicate that the 40-year term had been established on the basis of the reasonable foreseeable life of the plant without having to undertake major capital replacements. To consider lengthening the contract, the notes continue, there would have to be an engineering study to ascertain which components would last and which would have to be replaced or substantially repaired. Based on that information, and with a return-to-equity concept, Manning concludes it should be possible to project a flat mill rate with escalation for the loss of the PUITTA rebate and for additional capital costs. He also raises a concern about whether the risk would be too great to accept without an escalator for

operating costs. He then lists the 8% rental and the H.P. tax. The former is the 8% "rental" imposed by the Newfoundland government under CFLCo's lease, and which applied to CFLCo's pre-income-tax profits. The latter is the horsepower royalty of 50-cents per horsepower year. Presumably, Manning was noting that these would also have to be incorporated into an formula-based price for the extension period.

On the last line of his notes, Manning simply writes "Defeats purpose" although it is not entirely clear what that is in reference to.

Manning's notes constitute an attempt to think through what would be required if CFLCo were to agree to a fixed price for the renewal period. His conclusion is that, rather than a fixed price, there would have to be a formula for the price and that formula would have to incorporate:

- the cost of major capital replacements and repairs,
- the loss of the PUITTA rebate to CFLCo,
- the escalation in operating costs,
- the Lease's rental and horsepower royalty, and
- an agreed return on equity.

The key element of this formula is the return on equity. The project's economic rent may be defined as the difference between the economic value of the electricity and the cost of producing it, including the cost of equity. The three stakeholders - the buyer, the seller, and the resource owner - would somehow have to share the rent. For the seller, its share of the rent would be reflected in the rate of return on equity it could obtain for its shareholders.

As it turned out, such a formula did not become the basis for renewal. Hydro-Quebec sought a concession that allowed for none of the above.

**III. 6 A Do-or-Die Condition.**

On Wednesday, February 28, just 2 days after Manning's considerations, the negotiators met to discuss Hydro-Quebec's draft of February 18. According to Manning's record of this meeting several sections of that draft were discussed and a number of points agreed. CFLCo pointed out that elements of the Completion Guarantee Article, notably the provisions by which Hydro-Quebec would obtain shares if it were called on to make advances, were completely new and required detailed analysis. It was agreed that CFLCo would draft riders representing the

points that were discussed and that they would meet again with Hydro-Quebec on Friday. Manning's record described the meeting as cordial and noted that the Quebec government representatives "indicated a real desire in completing the contract as soon as possible." Renewal was not raised at the meeting.

On Friday, March 1, Hydro-Quebec's Boyd, De Guise, Gadbois and Lemieux, along with Lajeunesse for the Government of Quebec, met with CFLCo's McParland, Lambert, Tennant and Manning for further negotiations. Several issues were discussed and it was at this time that a major change in the renewal provision was put on the table by Hydro-Quebec. On this matter, Manning's record is:

> **Mr. Boyd pointed out that an extension of the term to Hydro-Quebec would have the same significance to them as the completion guarantee had to CFLCo, and he thought that Hydro should be given an option to renew flat at 2.2 mills per kilowatthour for 25 years or that an extension of the term for 25 years at this rate should be built-in to the contract. We explained the problems which this created, particularly in relation to the tax rebate and the consequent necessity for amendment to the existing statutory lease. This was a political consideration. There were also practical considerations, such as what escalation of wages we would be faced with 40 years after 1976 and what replacements of plant would be required during such an extension, notwithstanding the delicate political and practical considerations. We indicated sympathy with Hydro's request.**

Despite the diplomatic tone of the last sentence, a more revealing remark was included in Manning's hand-written notes taken at this meeting. Those notes are reproduced in Appendix II.

Interestingly these notes start with the "query" on renewing for a lesser amount of power at a reduced rate. The notes also reflect the considerations listed in Manning's February 26 analysis, such as the cost of replacement of capital, escalation of operating costs, and loss of the PUITTA rebate. They also indicate that CFLCo was reluctant to open the issue with Newfoundland; the "issue" appears to be the PUITTA rebate specifically. The most telling element of his notes is the phrase:

> **A Do or Die Condition.**

which is a clear and dramatic indication of his interpretation of Hydro-Quebec's new position on

renewal.

This request to replace the renewal clause came at a time when CFLCo had about 12 weeks of funds left and further financing was dependent on a deal being at hand. Moreover, this was an entirely new development. From the initial 1963 proposal and its subsequent drafts to the drafts of the Letter of Intent, the Letter of Intent itself, and persistently through all the numerous drafts of the power contract, including the one of February 1968, which Hydro-Quebec itself had prepared, the substance of the renewal provisions had remained the same. Following the expiry of the contract's term there was to be mutual agreement on price and quantity for the renewal and Hydro-Quebec would have a right of first refusal for sales for consumption in Quebec. Throughout the years of negotiations and discussions there was no indication of any desire of either party to substantially deviate from those agreed points. There is no record of any difference of opinion on this matter up to March 1.

Boyd's statement intimated a linkage between this change in the renewal and the Completion Guarantee. However, a completion guarantee had been part of a long-agreed quid pro quo: a low price regime in exchange for the assurance of advances, if needed, which would be repaid with interest. Hydro-Quebec had only in the previous month requested that it be additionally compensated, through more CFLCo shares, if it were ever to be called on for any advances under the completion guarantee. Now, Hydro-Quebec was seeking a substantial new concession for which there would be no reciprocation; it would apply even if the Completion Guarantee was never triggered.[25] There were no allowances for the items laid out in Manning's considerations of February 26. This demand was a complete departure from the renewal provisions in the Letter of Intent. It was on the basis of the Letter of Intent that CFLCo had launched its major construction program in order to meet Hydro-Quebec's schedule for first power. Those efforts had practically exhausted CFLCo's access to funds by the time this demand was advanced and, according to Manning's characterization, was put forth as a "do-or-die condition."

---

[25] The Economic Council of Canada (1980, p.121) also states that the renewal clause was not required for financing the project.

### III.7 CFLCo's Compromise Proposal

Following this meeting, CFLCo continued to work toward finalizing both the contract and a financing plan. On March 5, McParland wrote a memorandum to Boyd of Hydro-Quebec, forwarding revised drafts of sections dealing with the Completion Guarantee and related items. On March 6, there was another meeting between CFLCo and Hydro-Quebec and the Quebec government representatives. According to Manning's record of that meeting, a number of riders, which had been submitted to Hydro-Quebec the previous day, were agreed. They also reviewed a list of provisions that still needed to be settled. One of these was renewal, which CFLCo advised was under advisement but progress was being made and that CFLCo's response would be coming as soon as possible.[26] Later in the meeting, Cardinal suggested that the principal points that were still open were the definition of the Final Capital Cost of the Plant, the Completion Guarantee and Renewal. However, he offered no additional comment on renewal and only made a brief remark as to what should be included in the definition of the Final Capital Cost. Most of the remaining discussions related to the Completion Guarantee.

CFLCo's response to the Hydro-Quebec new position on renewal was contained in an internal memorandum, dated March 7, 1968, which listed 15 items that "appear to be required to complete the contract." The rider on renewal was attached and its key elements read:[27]

> **This Power Contract shall be renewed, on the basis stated in this Section, for a further term of 25 years from the expiry date hereof.**
>
> **Renewal of this Power Contract shall be evidenced by a new contract which shall provide as follows and be in the form and terms approved of by counsel for each of the parties respectively:-**
>
> **(a) sale and purchase of energy under such new contract shall be on a continuous energy basis, whereby, up to the limit of the number of kilowatthours per year which shall constitute, at the date of expiry hereof, the Annual Energy Base, Hydro-Quebec shall pay for all energy made available to it by CFLCo, whether or not taken;**

---

[26] See "CTM's record of meeting with Hydro-Quebec 6.3.68" p.2.

[27] The rider also noted that the first refusal section would not be necessary.

**(b) the price payable by Hydro-Quebec shall be payable in lawful money of Canada and the rate per kilowatthour applicable shall be the equivalent in Canadian dollars or 2.0 mills in U.S. funds;**

This compromise proposal offered a fixed price of 2 mills in US currency, which was approximately equal to the 2.2 mills in Canadian funds at the time. However, the rider offered CFLCo some scope to protect itself. First, the renewal terms were to be approved of by counsel. Secondly, a new contract would have to be drawn up and signed. Thirdly, and most importantly, provision (a) states that Hydro-Quebec would buy, up to a limit, all the electricity made available by CFLCo. That provision contained no lower bound on the amount that CFLCo could choose to make available to Hydro-Quebec, only an upper limit, namely the Annual Energy Base, which the draft contract put at 31.5 million megawatt hours.[28] The implication of this wording is that if CFLCo could sell some, or even all, of its power to another party then it would be able to do so. In short, while Hydro-Quebec would have a fixed price of US 2.0 mills for the 25-year period, CFLCo would at least retain the flexibility of choosing what quantity of power to sell to Hydro-Quebec at that price. This attempt to determine the amount of power to be sold to Hydro-Quebec at the reduced price was consistent with the "query" in Manning's handwritten notes of March 1; see Appendix II.

On March 11, the three parties met again. Most of the meeting dealt with matters related to financing. McParland outlined CFLCo's major financing plan for the project. Funds, totalling up to $1 billion would come from a number of sources but, under this draft plan, the major source would be through sale in the US financial markets of First Mortgage Bonds (FMB) in the amount of $550 million. CFLCo pressed Hydro-Quebec to lower the $700 million threshold, as provided for in the draft contract's Article V, as the amount that CFLCo would have to successfully raise. CFLCo wanted it lowered to $600 million, arguing for a time-phased approach which would allow CFLCo in the initial instance raise a smaller amount of funds, $340 million, through FMB. Then, if need be, CFLCo could go to the financial markets at a later date to raise any additional funds in a second round of FMB sales. The CFLCo negotiators reasoned that this would put Hydro-Quebec in a position where it would not have to put up any cash

---

[28] The contract allowed for modest adjustment of this figure at 8 and later 4-year intervals.

except if the second offering of FMBs could not be successfully marketed and, even if that happened, it would not be until 1971 or 1972. Apparently, CFLCo felt that such a time-phased offering would be easier to sell and would likely have more reasonable terms. Nevertheless, Hydro-Quebec's Boyd indicated that any reduction in the $700 million threshold was unacceptable. At that point, Manning's record reports that the CFLCo side pointed out that profitability had been "stripped down to the underwear" and that CFLCo "were in no position to give any further concessions."

The meeting then turned to major concession that Hydro-Quebec was seeking on renewal. CFLCo's rider was tabled. The record of the ensuing discussion on this matter is as follows:

> **Mr. McParland then dealt with the contract renewal and tabled a proposed revision to clause 3.2 which became numbered as <u>rider 34</u>. He pointed out that this suggestion had not received board approval; that management was prepared to support it but that it was still fraught with certain problems. Lajeunesse raised the question as to whether Hydro wanted a firm renewal or an option to renew, and it was decided that this should be considered by Hydro. McParland explained the reasons for the pricing arrangement and our fear of the effects of devaluation. Lajeunesse thought that it was probably preferable to append the renewal contract to the Power Contract and have it executed concurrently with the signature of the principal contract.**

Thus the CFLCo negotiators made the point that even its compromise proposal on renewal was "fraught with certain problems" but management would support it.

Towards the conclusion of the meeting, the other Quebec government representative, Jean Paul Cardinal, indicated that a report to the Quebec government was past due and that he wished to see the contract finalized that week. The parties then ended the meeting by agreeing on several actions to be taken, which, according to Manning's notes of the meeting, included a commitment by Hydro-Quebec to "indicate their agreement on riders 29 to 34 inclusive as soon as possible;" rider 34 being CFLCo's compromise proposal for renewal. It was also agreed that a clean version of the draft would be developed in which agreed sections would be included, and

those outstanding would be left blank.[29]

On March 14, the parties representing Hydro-Quebec, CFLCo and the Quebec government met again. At the beginning of the meeting, CFLCo suggested dealing with the outstanding riders, namely riders 29 to 34, that it had submitted to Hydro-Quebec. However, Lajeunesse responded that the Quebec side had not had enough opportunity to deal fully with that material, and he suggested that the meeting deal with various aspects of Article V- Completion Guarantee - and Article XII- Debt Service Requirement and Expenses Charges. The issues revolved around whether, if they were to be needed, any advances from Hydro-Quebec would be secured by general mortgage bonds rather than unsecured debentures. Then the meeting turned to a number of Hydro-Quebec's proposed riders to the February 18th draft. None appeared to be particularly contentious, and consensus on how to proceed or agreements were made on each. Interestingly, part way through the meeting, Jean Paul Cardinal reiterated that it was important to place a contract before the Quebec cabinet and he hoped to do so by Monday, March 18, just 4 days away. Presumably, this statement, plus the fact that neither the Hydro-Quebec nor Quebec government representatives had raised any problem with CFLCo's renewal proposal, would have given CFLCo some sense that its renewal compromise proposal was largely agreeable.

At the end of the meeting, the two parties agreed that the principal matters remaining for resolution were Articles V and XII. In that context, CFLCo indicated that they had sent the Hydro-Quebec draft to their financial advisors and New York counsel. Also, CFLCo indicated that meetings would be arranged early the next week (i.e., the week of March 18) "to examine the objectives that Hydro were endeavouring to achieve and determine ways and means in which these could be accommodated." CFLCo invited Hydro-Quebec to have their counsel participate in those meetings. The implication was that an agreement would not be possible by March 18, as Cardinal has hoped, but it appears that the parties were moving rapidly towards one, and there

---

[29] At least two incomplete versions appeared in March. One was in the form of the February 18th draft but with "as revised to 2.3.68" handwritten on its cover page and many sections inked with handwritten changes. This version still retained the renewal clause calling for mutual agreement. The second version was described as the February 18 draft "As revised to March 12, 1968." In it, the renewal and first-refusal sections were among those left blank.

was still no sign that CFLCo's rider on renewal was not acceptable.

Indeed in the next few weeks, events moved quickly both in terms of the contract and the financial plan, with Hydro-Quebec also becoming extensively involved in the latter.

### III.8 The Financial Arrangements

The fundamentals of the financing plan were agreed by April. The main elements may be briefly summarized as follows:

- New Equity. Hydro-Quebec wanted to increase its ownership position in CFLCo.[30] It was agreed that $25 million in new CFLCo shares would be issued and that the existing shareholders would subscribe for them in batches over the summer months of 1968. Hydro-Quebec would take $15 million of these shares so it could bring its overall ownership in CFLCo up to 25.7%. Newfoundland and Rio Algom would follow their respective interests at 10% and 10.4% respectively. The remaining shares would be taken by Brinco, which would see its overall interest decline to approximately 53.9% as a result.

- General Mortgage Bonds: It was agreed between CFLCo and Hydro-Quebec that $100 million in General Mortgage Bonds, with 10 bonus shares attached to each $1000 unit, would be offered to the four shareholders in accordance with their respective ownership positions. These would be taken up in the fall of 1968 so as to provide continuity in funding for CFLCo. Hydro-Quebec would under these arrangements be obligated to subscribe for any other units that were declined by the other three shareholders. (Later in 1968, Hydro-Quebec would change the conditions under which CFLCo would offer these bonds so as to give CFLCo the option to require Hydro-Quebec to take them exclusively, which was ultimately what was done.)

- CFLCo to raise $515 million: As a condition on the General Mortgage Bond arrangements, CFLCo had to agree to first obtain commitments of at least $515 million from investors, of which at least $415 million would have to be for First Mortgage Bonds.

- Special by-law 13: As a component of the arrangements, Hydro-Quebec required that the CFLCo Board of Directors approve a new by-law. By-Law 13 would require approval by those holding at least 75% of shares for certain decisions to be made. For instance, without 75% approval, this by-law provided that CFLCo could not engage in other projects, incur debt for purposes unrelated to the project and its operation, increase the authorized share capital, or amend or repeal the by-law itself. With Hydro-Quebec to

[30] See Minutes of Joint Meeting of the Executive Committees of the Boards of Directors of Brinco and CFLCo, April 10, 1968; p.2.

hold 25.7% before the end of the year, this would give it a veto over such matters.

- Voting Trust Agreement: An agreement was to be drawn up between Brinco and Hydro-Quebec by which a sufficient number of Brinco's CFLCo shares would be deposited with a trust company so that those shares plus those of Hydro-Quebec would total 50.1%. If CFLCo were to fail to pass or later rescind By-Law 13, or if it were to violate other specified conditions, such as being in default on debts, then the trust company would vote those shares in accordance with Hydro-Quebec's wishes. This would allow Hydro-Quebec to replace the majority of the CFLCo Board with individuals of its choosing. The Voting Trust Agreement would also direct the trust company to sell the deposited CFLCo shares to Hydro-Quebec if CFLCo failed to meet certain financial conditions.

### III.9 Contract Negotiations come to a De facto End

By early April the form of the contract was also reaching its final stages. It is also clear that CFLCo's rider 34 had been a fruitless effort. On April 10, 1968, when CFLCo would have been close to exhausting its available funds, the executive committees of the CFLCo and Brinco boards, which included Donald McParland and C.T. Manning, held a joint meeting.[31] At that time, they considered the points on which Hydro-Quebec was insisting. The minutes of the joint meeting indicate that CFLCo President, Donald McParland, presented the Hydro-Quebec demands and, as a preface to doing so, indicated that they "had been substantially reduced from those originally presented."

One of the demands was in regard to renewal. According to the minutes

> **Hydro-Quebec wished to be able to project a lower mill rate than the present draft of the contract permitted. Due to increased costs and escalation the effect of the present term of 44 years from first delivery or 40 years from completion indicated an average mill rate considerably in excess of that contemplated in 1966. Accordingly, they had requested a 25 year extension of the contract on a flat mill rate basis suggested at two mills per kilowatthour. They wished this to be in the form of an option. This would produce a gross revenue of $60-65 million per annum. There would be no debt outstanding. Should CFLCo attempt to qualify the rate by the addition of escalators or make any provision for its tax position, the purpose of the extension would be defeated. Although the Churchil (sic) project was**

---

[31] The other members were Donald Gordon who was Chair, and Henry Borden, Senator Maurice Bourget, Sam Harris, M.F. Nicholson, E.L. de Rothschild, and A.S. Torrey. Val Duncan was also a member but was not in attendance. CFLCo's E. Lambert attended the meeting by invitation.

**marginally more attractive then (sic) nuclear power today, it was conceivable that it would not be in 40 years' time. It was obvious that a commitment on the extension was preferable to an option and it also appeared desirable to endeavour to have the mill rate expressed in either U.S. or Canadian funds at the option of CFLCo in order to afford the greatest protection against serious devaluation of the Canadian dollar.**

This excerpt is revealing in a number of ways. First, it does not mention the attempted compromise of rider 34, which suggests that the rider was ineffective and that the Executive Committee may not have been informed about it. Secondly, none of the complications such as higher costs, loss of tax concessions, and needed capital replacement, as anticipated by Manning's notes of February 26, was mentioned in the minutes of the joint meeting. All that is mentioned is that any attempt to include escalators would defeat the purpose. Thirdly, the excerpt points out that costs and therefore the mill rate would be higher for Hydro-Quebec than anticipated in 1966 but that was generally true for its alternative sites. Finally, the prospect of nuclear energy being cheaper in the future is presented as speculation; there is no report or study cited.

The presentation to the Executive Committee does not mention perhaps the most important consideration, namely, without an agreement within weeks CFLCo would be unable to pay its bills. Additionally, McParland's prefacing statement that Hydro-Quebec had substantially given ground on its demands is untrue in regard to renewal. According to Manning's notes of the meeting of March 1, Hydro-Quebec had sought renewal for 25 years at 2.2 mills flat. Even if one were to assume that Manning's notes contained a typographical error so that the suggested rate was indeed 2.0 mills originally, there was no reduction in Hydro-Quebec's position

The joint meeting concluded by endorsing the negotiating team's positions on the key points and authorizing them to conclude the negotiations. Those positions essentially involved agreeing to the Hydro-Quebec demands but with efforts to negotiation modifications to CFLCo's interests where possible.

On April 15, McParland sent a draft contract, dated April 12, to Hydro-Quebec. That draft was incomplete, containing only the sections that had been agreed to date and with remaining sections left blank. Appended to it were 20 pages of riders and related materials for

discussion and incorporation; among items covered in those pages was Article XII but there was nothing on Article V or the renewal section. However, penned in this draft in the area where the renewal was to appear was a note "Awaiting HQ comment on CFLCo submission due April 16." Presumably, the response was to answer whether Hydro-Quebec would be agreeable to granting CFLCo the option of being paid 2.0 mills in US rather than Canadian money.

The next complete draft was dated April 19, the first complete one since the February 18th version. It included a number of concessions by CFLCo. This draft's Article V, the completion guarantee, provided that not only would CFLCo have to repay, with interest, Hydro-Quebec for any advances made to it but it would have to issue and turn over 10 new shares to Hydro-Quebec for each $1,000 advanced. This draft also extended the shares-for-advances principle to Article XII.[32] As for renewal, the terms were as follows:

> **This Power Contract shall be renewed on the basis stated in this Section, for a further term of 25 years from the expiry date hereof.**
>
> **The renewed Power Contract, on the basis of a sale and purchase of continuous energy whereby a number of kilowatthours per year equal to that which shall constitute, at the date of expiry hereof, the Annual Energy Base, shall be made available by CFLCo to Hydro-Quebec and the latter shall pay for it, whether taken or not, at a price of 2.0 mills per kilowatthour payable monthly.**
>
> **During the period of renewal the terms, clauses and conditions of such renewal shall be those set forth in the present Section and Schedule III hereof, which shall apply automatically without any further signature being required. All or any Article or Section of this Power Contract as well as all or any undertakings or promises, not specifically contained in the present Section or in Schedule III shall have no force and effect and shall not be binding upon the parties to the renewed Power Contract.**

None of the elements of CFLCo's attempted compromise, rider 34, had been incorporated. This new renewal section compelled CFLCo to sell essentially all the power from the plant at a price fixed at just 2 mills starting around the year 2017, approximately 50 years in the future, and continuing for 25 years thereafter. There was no consideration of any of the

---

[32] If CFLCo were to ever call on Hydro-Quebec under Article XII, the latter would receive either 5 shares per $1000 advanced or 10 shares per $1000 in the event that the plant was destroyed or damaged to the point of being inoperative. The advances would have to be repaid to Hydro-Quebec with interest.

allowances that Manning had listed in his February 26 analysis. Even the final efforts to obtain an option to have the price payable in either U.S. or Canadian currency failed. This apparently ended the matter.

In a letter dated April 23, Robert Boyd of Hydro-Quebec sent drafts of the financial arrangements as well as drafts of the Voting Trust and By-Law 13 to CFLCo. In that letter he then stated that, conditional on CFLCo's acceptance of those documents, Hydro-Quebec was prepared to recommend the draft contract to the Quebec government for approval. Two more drafts followed in April – including ones dated April 25 and April 29 - but largely included small changes and clarifications with no more substantial concessions.[33]

On May 14, the Executive Committee of CFLCo and the Executive Committee of Brinco held another joint meeting. It was reported that Hydro-Quebec's agreement was contingent on the various financial arrangements. Those present voted to authorize CFLCo to enter an agreement substantially in the form of the April 29th draft and to agree to the related financial conditions.[34]

On June 13, 1968 the Board of Directors of CFLCo met. This meeting occurred at a time when CFLCo effectively had no money. Smith (1975; p.289 ) reports that CFLCo was sending staff with signing authority out of the office in order to have an excuse not to pay bills.

The Board consisted of 14 members, including the 7 who were on the Executive Committee.[35] Information was provided to the Board members in summary form in a confidential memorandum that was distributed at the meeting and which had to be returned at the

[33] Section 15.1 of the April 29th draft provided that if CFLCo recalled power then Hydro-Quebec's contribution to interest costs would be proportionately reduced; this was a further concession to Hydro-Quebec compared to the April 19th draft.

[34] CFLCo's Executive Committee consisted of seven members of its Board. According to its Annual Report for 1968, they were Henry Borden, Val Duncan, Donald Gordon, Sam Harris, Donald McParland, Edmund De Rothschild and Arthur Torrey. All seven were also members of Brinco's Executive Committee along with Quebec Senator Maurice Bourget and M. F. Nicholson, Brinco's vice-president and general manager.

[35] Only one of the other seven directors represented Newfoundland's interest. George Hobbs was chairman of the Newfoundland and Labrador Power Commission, and had been appointed to the CFLCo Board in June 1964.

end of the meeting. Specifically, according to Minute 386 of this meeting,

> **To avoid reading at length the minutes of the Executive Committee Meeting of April 10 and May 14, 1968 which had been held jointly with the Brinco Executive Committee Meeting, a memorandum summarizing the actions taken by the Executive Committee at these meetings was distributed to the Directors present. In view of their confidential nature the Chairman requested that each Director return his copy of the memorandum at the close of the Meeting. The memorandum was then read by Mr. Manning to the meeting.**

The 8-page memorandum devoted 6 lines to renewal, informing the readers that it was to be in the form of a firm commitment at a flat rate of 2 mills in Canadian dollars.

Board members in attendance, including Jean-Claude Lessard, unanimously approved all the actions taken by the Executive Committee, as summarized in the memorandum circulated at the meeting. The Board then specifically ratified and confirmed the Executive Committee's decision taken at its May 14th meeting to enter into a power contract substantially in the form of the draft of April 29.

Thus, before the end of April 1968, negotiations had effectively ended. CFLCo had made several concessions and it had completely capitulated to Hydro-Quebec's demands regarding renewal.

## IV. IMPLICATIONS OF THE RENEWAL CLAUSE

This section attempts to ascertain the implications of the 2-mill renewal clause and to do so in the context of the times. That is to say, the approach herein is to assess how the key parties would have evaluated the implications in 1968, not to look at the implications with the benefit of hindsight. The three key parties were the Quebec side, namely Hydro-Quebec and the Quebec government, CFLCo, and the province of Newfoundland. These are dealt with in turn, starting with Quebec.

### IV. 1 Quebec

In the first week of June, 1968 Hydro-Quebec adopted a resolution approving the draft power contract subject to the approval of the Quebec government. By this time, a draft of the

contract dated May 20, 1968 had superceded the April 29 draft and was basically a cleaned-up version of it.

In a letter dated June 6, 1968, Hydro-Quebec then made its formal recommendation to Quebec Premier Daniel Johnson to accept the agreement. That letter, written by Jean-Claude Lessard, presented a synopsis of the main considerations that justified its recommendation:

- investment expenditures by Hydro-Quebec would be reduced;
- annual operating costs would be lower when compared to the alternatives;
- the cost of energy would be lower than the alternatives; there would be work for Quebec manufactures and contractors, and
- Hydro-Quebec would own a minimum of 25.7% of CFLCo.

Another of the main considerations listed in the letter was the renewal clause. In that regard Lessard's letter states:

> **The Letter of Intent between Hydro-Québec and CFLCo signed in 1966 called for a 40-year contract with the possibility of renewal at a rate to be discussed before 2005.**
>
> **In the attached agreement, Hydro-Québec has an automatic renewal for a period of 25 years at a rate of 2.0 mills/kWh without escalation. This is a considerable improvement over the Letter of Intent when it is noted that a difference of 1.0 mill "kWh represents a saving of about $30,000,000 per year.**

Lessard's letter concluded that the agreement was to "Hydro-Quebec's greatest advantage" and requested the government to authorize the signing of it and the related documents.

Several supporting documents were enclosed with Lessard's letter, including the draft power contract, the various financial arrangements, drafts of Special By-Law 13 and the voting trust agreement, a document comparing the Letter of Intent with the draft contract, and a Hydro-Quebec report entitled "Hydro-Quebec Construction Program"dated April 19, 1968.

The "Hydro-Quebec Construction Program" report compared three alternatives for adding to its electricity capacity from 1968 to 1980. Those options were the "Churchill Falls program," the "thermal-nuclear program" and the "thermal program." The two main criteria by which these programs were ranked were: initial construction cost and annual cost. The latter included interest, depreciation, operation and maintenance in addition to fuel for nuclear and

thermal units and the cost of purchased power. The Churchill Falls program was ranked first and the thermal-nuclear program second. The Churchill Falls program itself covered 1968 to 1980 and was a mix of the purchase of power from Churchill Falls beginning in 1972 and the building of additional capacity in Quebec to become available beginning at various times from 1977 to 1980. For this program, the annual cost of electricity for the years 1980 to 2015 was estimated at 5.35 mills but the Churchill Falls' component of this average was put at 4.70 mills, inclusive of transmission line costs in Quebec. The implication was that the remainder's annual costs were higher than 5.35. Thus, Hydro-Quebec's analysis indicated that not only was Churchill Falls more attractive than the alternative thermal-nuclear program, but it was also superior on an annual-cost basis to the set of remaining components of the Churchill Falls program.

In addition to this attractiveness over the 1980 to 2015, the Hydro-Quebec report identified the additional gains associated with the new renewal clause. It stated that:

> **The extension of this contract for another 25 years, at a price of 2.0 mills/kwh, not subject to cost escalation, offers benefits for Hydro-Québec. In the first place, Hydro-Québec would not be obliged to plan for the construction of power stations in 2015 to replace Churchill Falls power. This investment would be pushed forward to the end for the 25-year period, around 2040. Secondly, for every 1 mill/kwh difference between the cost price of energy from another source and the purchase price of 2.0 mills/kwh, Hydro-Québec earns $29 000 000 per year for the 25 years, or $725 000 000.**

The Construction Program report did not speculate on how large that mill difference might be by 2017 and thereafter. However, a difference of just 8 mills during the renewal period would translate into almost a quarter of a billion dollars per year to Hydro-Quebec's advantage.

Another document, also enclosed with Lessard's letter, was the one that compared the draft contract agreement with the 1966 Letter of Intent. It echoed the conclusions of Hydro-Quebec's Construction Program report. This comparison document noted that the cost of the project would be higher than anticipated in the Letter of Intent. In part this was due to the addition of an eleventh turbine but also due to financial market conditions, which made it more difficult for CFLCo to obtain funds, plus interest rates were higher. It also stated that potential first-mortgage bondholders required that Hydro-Quebec's advances/loan guarantees not be limited to the $109 million provided for in the Letter of Intent. Nevertheless, it opined that:

> **In view of the fact that the costs of the project and of borrowing money have increased since the date of the Letter of Intent, facts which are beyond the control of either CFLCo or Hydro-Québec and as applicable to the CFLCo project as to any other, we believe that the draft agreement and accompanying documents as submitted contain assured advantages for Hydro-Québec compared to what was provided by the Letter of Intent.**

It then listed those advantages over the Letter of Intent. The renewal clause was identified as one of them and it was noted that:

> **The rate of 2.0 mills is very low in itself and considering the way in which the purchasing power of money has declined since the beginning of the century, it is an extremely advantageous rate for Hydro-Québec, even at this time.**

In short, in 1968, based on its own assessment, Hydro-Quebec would have anticipated that the gains to it resulting from the new renewal clause would be in the hundreds of millions of dollars annually for the 25 years in question.

### IV. 2 CFLCo

The implications of the new renewal clause for CFLCo, assessed from a 1968 perspective, would have been very bleak. With very good luck it might be able to cover the cost of providing the power to Hydro-Quebec, but it faced a greater chance that it would make losses, possibly substantial losses especially during the latter years of the renewal period.

It would have been reasonable to assume that Hydro-Quebec would take approximately 29 to 30 billion kilowatt hours annually during the renewal period; this amount anticipates that CFLCo will have recalled its allowed maximum of 2.4 billion kilowatt hours. At a price of 2 mills, Hydro-Quebec would be paying CFLCo approximately $58 to $60 million annually during renewal. From this revenue, costs, including taxes, would have to be paid. Assessed from the perspective of 1968, it would have been very unlikely that this revenue would be sufficient to cover costs.

Plant operating costs and corporate expense alone would be considerable that far into the future. CFLCo's own forecasts in 1968 anticipated that in 1977, plant and corporate expense

would be \$7.8 million and would escalate 3% annually.[36] The table below illustrates that using that escalation rate, the cumulative effect over such a long period of time is quite substantial. It would mean that during the renewal period these costs would average \$37 million annually and therefore would alone consume more than 60% of the \$58 to \$60 million that Hydro-Quebec would pay to CFLCo. The table also illustrates the sensitivity of such projections to small increases in the escalation rate. For example, if the escalation rate actually turned out to be 3.5% these costs would average \$48 million annually during renewal exhausting 80% of the revenue. A rate of 4% or more would imply that these costs could actually exceed the payments made by Hydro-Quebec.

| Escalation Rate from 1977 | Average annual Plant and Corporate Expenses during the Renewal Period: 2017-2041 |
|---|---|
| 3.0% | \$37.0 million |
| 3.5% | \$48.0 million |
| 4.0% | \$62.2 million |

In the context of the times, namely mid-1968, a 3% escalation rate for future costs appears to have been the norm. However, the length of time into the future - approximately 50 to 75 years - would likely have reduced the comfort level associated with the use of any escalation rate, especially in the circumstance where revenue would be largely fixed. Manning's notes of February 1968 (see Appendix I) well anticipated this uncertainty. His notes contained a remark to the effect that CFLCo would have to consider whether or not the risk associated with rising operating costs would be too great to accept without an escalator.

Even if operating costs escalated at 3%, there would still be other costs to consider. Plant, equipment and other structures would tend to wear out and need replacement over time. By the beginning of the renewal period, components of the powerhouse, reservoir, transmission lines and other structures, other than those that may have been already replaced, would be between 40 and 50 years old. With the further aging of the physical plant, there would be a considerable likelihood that major components would have to be replaced during the renewal period. Again, Manning's notes anticipated this need; those notes indicated that for the 40 years

[36] CFLCo ledger sheets, dated July 22, 1968 have projections of Plant and Corporate Expenses based on an escalation rate of 3%.

following completion, replacements of major components were not anticipated but that an engineering study would be needed to consider replacements after 50 or 60 years. To illustrate, allowing for 2.5% escalation in capital costs starting from 1976, a capital item would cost 3 times more in 2021 than in 1976 and 2021 would be just five years into the renewal period. To the extent that capital replacements were needed, CFLCo would have to devote its revenues to financing them, either directly or by servicing debt incurred to pay for them.

Additional costs would also come into play. CFLCo, under its 99-year water-rights lease, was obliged to pay a horsepower royalty to the Newfoundland government in the fixed amount of approximately $2.6 million annually. Tax relief, in the form of exemptions from sales and fuel taxes as well as from increases in other taxes and from new taxes, that had been provided by the provincial government did not extend to the renewal period. Even if CFLCo managed to make any profit during some years of the renewal period, the PUITTA rebate will have expired so those profits would be subject to the full federal corporate income tax rate.

There was a further risk at play for the other shareholders in CFLCo. If, as provided for under Articles V and XII, CFLCo ever had to seek advances from Hydro-Quebec then in addition to having to repay Hydro-Quebec, it would have to provide new shares to Hydro-Quebec. That would result in the dilution of any returns due to the other shareholders. The provisions for advances were in the contract largely to assure bondholders that their investments were safe rather than to be actually acted upon. Still, this was a risk that the other CFLCo shareholders had to bear.

Other than for the Hydro-Quebec contract, CFLCo would have few other sources of revenues. Earnings would come from sales of the Twinco block as well as from the modest amount of power available from recall. However, the revenue from the Twinco block was not actually new revenue. If the Churchill Falls development had not taken place then the water for the Twinco generating station would not have been diverted and that facility would have generated its own revenue. The only truly additional revenue would be from any sale of recall power. The maximum amount that could be recalled by CFLCo was approximately 2.3 million megawatt hours per year, which would leave Hydro-Quebec with approximately 29 to 30 million megawatt hours. The sale of that relatively small amount would bring revenue to CFLCo but, unless sold at a substantially higher price than 2 mills, would only marginally improve the

overall outlook. And, if sold at a higher price would serve largely to subsidize the contract with Hydro-Quebec.

Considering rates of cost escalation as anticipated in the 1968 context, the very likely need for major capital replacements after 2016 and the loss of tax advantages, the shareholders of CFLCo would have had little basis on which to expect any positive return during the renewal period. In acquiescing to Hydro-Quebec's do-or-die condition, CFLCo's management would have understood at the time, that it had effectively placed its shareholders in a position such that during the 25-year-extension they would likely have to suffer losses or would have very modest and capped earnings at best. Two mills was, at the time, likely the lowest conceivable price at which CFLCo could be expected to cover costs during the renewal period.

For certain, without a future amendment to the 2-mill 25-year renewal clause, CFLCo would have no prospect whatsoever to share in any increase in the market value of its product. The fact that, following its failed attempt to obtain less onerous renewal terms, CFLCo accepted the new renewal clause attests to CFLCo's and Brinco's assessment of the credibility of Hydro-Quebec's ultimatum of March 1, 1968. It had come at a time when CFLCo was close to exhausting its cash and when Brinco was in no position to help. Brinco itself was in the midst of a financial crisis brought on by having to borrow over $20 million from the Bank of Montreal to support the CFLCo share issue of October 1967. Without an agreement on the contract, CFLCo would have no options left other than the "die" one.

### IV. 3 Newfoundland

The implications of the renewal condition for Newfoundland, as resource owner, were largely the same as those for CFLCo. The main mechanism by which Newfoundland was to capture some of the economic rent from the project was through an 8% rental on CFLCo's pre-tax profit. With little or no prospect for significant profit during the renewal period, that 8% would yield little or no revenue. By the same reasoning, the provincial corporation income tax would yield little or no revenue. After the beginning of renewal, the provincial government would stand to retain all the PUITTA rebate but, without CFLCo earning any profit, that would be of little or no value. The only revenue of which that Newfoundland could be relatively certain

was the horsepower royalty revenue. It had been established in the statutory water power lease with CFLCo. It was a fixed amount of approximately $2.6 million per year and unrelated to revenues or profitability; rather, it was based on the amount of power generated.

Thus, it was most unlikely that Newfoundland's royalty and tax revenue from Churchill Falls would be more than a few million dollars per year during the renewal period. That compares dramatically with Hydro-Quebec's anticipation of earning between $29 and $30 million per year for each mill difference between the cost of alternative sources and 2 mills.

The Newfoundland government was not party to the contract negotiations. The first that Premier Smallwood was to learn that the renewal clause had been replaced was from a telephone call from Donald Gordon, the CFLCo board chairman. Gordon, who was also Brinco president and chief executive officer, called on July 12, two days after the Quebec government's authorization to Hydro-Quebec to proceed with finalization of the deal. July 12 was also the same day that Hydro-Quebec issued its press release announcing the decision to proceed with the project; that six-paragraph release devoted one paragraph to renewal. Gordon kept a record of his telephone conversation with Smallwood, who is referred to using the initials, J.S. That record is as follows:[37]

> **I called at exactly 10.00 a.m.**
>
> **I said I was calling to confirm that the Order-in-Council authorizing Hydro Quebec to execute the power contract had been received and that Hydro Quebec was making a press release this morning. I gave him a summary of it.**
>
> **I also read Mr. McParland's statement to the Press.**
>
> **J.S. expressed his gratification and congratulations. He asked about the actual signing of the Contract and I repeated that this would be forthcoming as soon as financing had been arranged and told him the Bond Memorandum was actively in hand through Morgan Stanley. I said I could not give any firm date until we have the report by Morgan Stanley but I estimated this might be around end of September. I asked J.S. not to use this date and he said he quite understood.**

---

[37] See "Notes of Telephone Conversation with J.R. Smallwood, Premier of Newfoundland on 12 July 1968."

**I said there was one special point mentioned in the Hydro Quebec announcement, namely the extension of the Power Contract for 25 years at a fixed price of two mills. His first reaction was that this looked like pretty cheap power. I reminded him that the Letter of Intent gave Hydro Quebec the right to renew and that all things considered we felt it to be a good deal to have the terms settled now. Moreover, by the end of the forty year contract the property should be debt free and its operating costs at minimal levels. Hydro Quebec had asked for an option to renew at the price mentioned but we had negotiated for a firm commitment as being in our best interests. J.S. said this was a matter of judgment and he had no further comment. He seemed quite relaxed.**

This record is very informative. Gordon started by telling Smallwood that there was an agreement and that the CFLCo and Hydro-Quebec press releases were in the process of being made public. It was only after Smallwood expressed his congratulations on the deal that Gordon raised the issue of the renewal, and indeed it was the only issue he raised.

When told of the renewal, Smallwood's remark about the renewal price of 2 mills constituting "pretty cheap power" shows that he had an appreciation of the implications. Gordon's response to Smallwood that the Letter of Intent gave Hydro-Quebec the right to renewal was highly misleading. It was true that the Letter of Intent gave Hydro-Quebec the right to renew but the Letter's renewal clause provided for negotiations for mutually satisfactory terms on price, quantity and other conditions. The original renewal clause had been public knowledge since the October 1966 press release announcing the agreement on the Letter of Intent. Its substance had been retained in all the drafts up to March 1968. Smallwood would have had no reason to expect that it had been replaced.

Also, Gordon's remark to Smallwood that by the end of the 40-year contract costs would be minimal and the project debt free was either dishonest or misinformed. Manning's notes had anticipated the need for an escalator for operating costs and for adjustments for major capital replacements as well as other considerations. CFLCo's own cost projections at the time used a 3% escalation rate and had placed annual operating costs at the beginning of the renewal period at more than $25 million.[38] And as pointed out above, a 3% escalation rate implies an average

[38] See ledger sheets, dated July 22, 1968, from CFLCo files.

annual operating cost of $37 million during the renewal period.

Gordon's final observation on the telephone conversation, namely that Smallwood "seemed quite relaxed," is open to interpretation.

The news of the deal and the new renewal clause had been presented to Smallwood as a fait accompli. The press releases were being made public. In the preceding weeks, Smallwood had agreed that Newfoundland subscribe for 10% of the forthcoming $25 million share issue in CFLCo, and had arranged budget funding for it at the end of June. Over the preceding two years, legislation had been passed or amended by his government that made needed adjustments in CFLCo's Lease, that gave relief to CFLCo from provincial sales taxes, and that provided for the transfer of the half the PUITTA rebate to the province on to CFLCo so it could offer a lower price to Hydro-Quebec.[39] Earlier Smallwood himself had successfully appealed to the federal government to increase the PUITTA rebate to enable this transfer to take place. As far back as the 1950's it had been appeals by Smallwood to British Prime Minister Winston Churchill, the Rothschild merchant bankers and other leading British industrialists and financiers that led to the formation of Brinco.

The telephone call from Gordon extended the do-or-die condition that CFLCo had faced to Smallwood.

Thus, it appears that Smallwood had an inkling of the implications of renewal but did not pursue the matter; neither did any other provincial politician or policy-maker. This is a moot point since Newfoundland was not a party to the contract.[40] Also, on July 15, just three days after the telephone call to Smallwood, Brinco and Hydro-Quebec signed Voting Trust

---

[39] The Churchill Falls (Labrador) Corporation Limited (Lease) (Amendment) Act, 1966-67, exempted CFLCo, as well as its contractors and subcontractors, from the provincial retail sales tax and gasoline tax, in so far as the purchases were related to the development of electricity. The amendment also provided that 47.9% of all tax collected by the federal government and rebated to the provincial government be turned over to CFLCo for the life of the contract, i.e., the PUITTA rebate. In addition, the legislation provided that CFLCo would be exempt from any increase in existing provincial taxes and exempt from any new taxes, royalties, dues etc. during the term of the contract.

[40] Under a covering letter dated May 10, 1969, CFLCo's C. T. Manning sent a copy to the Minister of Justice.

Agreement No.1. Brinco was required to deposit enough of its CFLCo shares with a trust company so that those shares plus the amount held by Hydro-Quebec amounted to 50.1%. Under the terms of the trust agreement, if CFLCo failed to raised at least $515 million in financing by December 15 then the trustee was required to vote with Hydro-Quebec, allowing it to replace the majority of the CFLCo Board of Directors with individuals of its choosing. Moreover, if CFLCo failed to obtain the $515 million by the deadline but did so afterwards then Hydro-Quebec would have the right to buy the deposited shares, at a price of $15 each, thereby giving it 50.1% ownership. The implication of the agreement was that anything that jeopardized financing would ensure Hydro-Quebec control and possibly result in it taking majority ownership of CFLCo.[41]

## V. EPILOGUE

Following the July 1968 announcement of an agreement, CFLCo's main tasks were to continue work to meet Hydro-Quebec's schedule and to arrange commitments for the major financing. Under a voting trust agreement, it had to complete the latter before year's end or control of the project would pass to Hydro-Quebec. For the rest of the year, CFLCo would be financed by the funds raised in the $25 million share that was initiated in July and was limited to the existing shareholders. Brinco would take up only about $5 million in those shares, and even to do that it had to borrow the funds from the Bank of Montreal. According to Smith (1975, p.299) a reluctant Bank was agreeable to do so only when Brinco produced a letter from Sir Mark Turner, a senior officer with Rio-Tinto Zinc as well as a member of Brinco's Board of Directors, indicating that a rescue plan for Brinco was in the works.

In August of 1968, Rio-Tinto Zinc put that rescue plan into place. First, it purchased shares in Brinco directly. Then there was a public offering of new Brinco shares in November, which Rio-Tinto supported by taking any shares that were not subscribed for. These new funds were sufficient to permit Brinco to repay its debt to the Bank of Montreal and to buy out Rio Algom's interest in CFLCo. According to Brinco's Annual Report for 1968, Brinco was then in

[41] A second voting trust agreement made similar provisions to protect by-law 13 and also provided for Hydro-Quebec purchase of majority ownership if CFLCo had to obtain loans from Hydro-Quebec to support its debt and other expenses during the term of the contract.

a position where it held almost 5 million shares in CFLCo for which it had paid $49.7 million over the years.

Later in the year Hydro-Quebec subscribed for all the general mortgage bonds, which carried with them one million bonus shares in CFLCo. No opportunity to purchase any of these bonds was made available to the remaining two CFLCo shareholders. Rather, in a letter to Hydro-Quebec dated November 18, 1968, CFLCo president McParland limited the offer to purchase the General Mortgage Bonds to Hydro-Quebec "alone as sole offeree."

The effect of these transactions for CFLCo, by the summer of 1969, was an ownership structure as follows:

| | |
|---|---|
| Brinco | 57.0% |
| Hydro-Quebec | 34.2% |
| Newfoundland | 8.8%. |

The remaining financing arrangements, namely, commitments for all the first-mortgage bonds and a loan agreement with a consortium of Canadian banks, were successfully in place by the fall of 1968. The contract continued to be re-drafted during the latter half of 1968 and into the early months of 1969 but the changes were largely technical and legalistic. Finally, on May 12, 1969 at Hydro-Quebec's offices in Montreal the contract was signed by the two parties to it. Jean-Claude Lessard, who had approved the contract as a CFLCo Board member, and Yvon De Guise, signed for Hydro-Quebec. Signing for CFLCo were Donald McParland and Eric Lambert. Several related agreements involving financing were signed the following days.

The project was successfully financed, and the completion guarantee never invoked. The plant was fully completed in 1976. In the interim, there had been a change in ownership. After holding office since Newfoundland became part of Canada, the Smallwood government had been defeated. The new provincial government, for reasons unrelated to the contract, embarked on a different approach to hydro-electric development.[42] After threatening expropriation of Brinco, it

[42] Among other things, the Newfoundland government was concerned that Brinco was an obstacle to developing hydro-electric sites on the lower Churchill River and it was unwilling to give the same favourable tax concessions that had been put in place for the upper Churchill development. Also, buying Brinco's shares in CFLCo resulted in the latter becoming exempt from federal corporate income tax so the PUITTA rebate ceased to apply. For more on the

reached an agreement in 1974 to purchase all of Brinco's shares in CFLCo, for which it paid $130 million, as well as Brinco's water rights to the lower Churchill River, for which it paid $30 million. This meant that the provincial government, through its Newfoundland and Labrador Hydro Corporation, then held 65.8% of CFLCo and Hydro-Quebec owned the other 34.2%. Shortly thereafter, CFLCo's offices were moved from Montreal to St. John's.

## VI. CONCLUSION

This paper is the first systematic explanation of the Churchill Falls contract's renewal clause. The findings may well raise substantive questions of business ethics and law.

From the beginning of negotiations in 1963, the original the renewal clause provided for future negotiations between the parties for another sale agreement following the contract's expiry. After three years of negotiations, the 1966 Letter of Intent embodied that type of renewal clause, with a provision that gave Hydro-Quebec the right of first refusal if, in the absence of a negotiated renewal, CFLCo were to offer electricity for sale to other parties for consumption in Quebec. These were entirely reasonable arrangements. By contrast, they were replaced in April of 1968 with a new clause that Hydro-Quebec had demanded, and which gave it practically all the power at a fixed price of only 2 mills for 25 years after the expiry of the contract's term. That price was significantly lower than the cost of any then available source. Without the benefit of hindsight, but in a 1968 context, these new terms for renewal were entirely one-sided. Even with the low-inflation expectations of the times, 2 mills was probably the lowest conceivable price at which CFLCo's future costs could be covered. Therefore, all the economic rent would be Hydro-Quebec's. In 1968, Hydro-Quebec's own estimates implied that the resulting gains to it would be hundreds of millions of dollars annually. Whether the rent turned out to be higher or lower, Hydro-Quebec would always be assured of all of it. None could accrue to CFLCo or to the resource-owner. Yet, both had conceded much to make the low-price contract a reality.

The Smallwood regime, representing the resource owner, had given much support to the project's economics, such as tax concessions and protection against new taxes and tax increases

---

purchase of Brinco's water rights and interests in CFLCo see Smith (1975) and Crosbie (1997).

during the term of the contract. Smallwood had lobbied the federal government to enrich the PUITTA rebate so the increase could be turned over to CFLCo. These concessions were ultimately to the benefit of Hydro-Quebec as they allowed CFLCo to lower its price. They were put in place during the time when renewal was based on the notion of future mutual agreement. Similarly, all the provincial government's equity contributions were provided either before the change in renewal or before Smallwood was told about it. Despite these benefits provided to it via Smallwood's arrangements, Hydro-Quebec demanded a change in the renewal clause which would ensure that future provincial governments would receive practically no benefits during the renewal period.

As for CFLCo, its former president, Robert Winters, had acceded to Hydro-Quebec having an ownership stake in CFLCo as well as a position on its Board. Also, he had broken the impasse in negotiations in 1965 by offering a low-price, cost-based, contract for a lengthier term of 40 years in return for certain Hydro-Quebec undertakings. That led to the Letter of Intent of 1966. It was on the basis of that signed agreement that CFLCo undertook an expenditure program designed to meet Hydro-Quebec's schedule for power requirements. Also, all the complete drafts of the contract until April 1968 contained a renewal clause consistent with the Letter of Intent's. Its replacement with a completely different and exploitive provision came when CFLCo's funds were nearly completely exhausted and it needed an agreement on the contract to survive; a fact that Hydro-Quebec's president knew by virtue of his position on the CFLCo Board. As Manning's notes of March 1, 1968 indicate, CFLCo understood Hydro-Quebec's demand for a 2-mill renewal to be a "do or die"condition and understood its implications. CFLCo attempted to obtain less onerous renewal terms but that effort was ineffective. It had to accept a price, beginning in the fall of 2016, that Robert Winters had rejected in 1964 and which was, according to Hydro-Quebec's own analysis, "extremely advantageous" for it even in 1968. Two mills was almost 20% cheaper than the 2.4 mills Hydro-Quebec's own advisory committee had recommend in its June 1964 report and that price was for their suggested term of 35 years, not for any subsequent period.

It is inconceivable that any party to a transaction would knowingly and willingly agree to sell its services some fifty to seventy-five years in the future at a price fixed below the current price, except if either forced to do so or offered commensurate compensation. In this case, the latter did not happen.

## REFERENCES


British Newfoundland Corporation, *Annual Report*, various years.

Churchill Falls (Labrador) Corporation, *Annual Report*, various years.

Churchill, Jason L., "Pragmatic Federalism: The Politics behind the 1969 Churchill Falls Contract," *Newfoundland Studies*, 15/2 (Fall 1999), pp. 215-46.

Crosbie, John C., *No Holds Barred: My Life in Politics* (Toronto: McClelland & Stewart 1997).

Dorion, Henri, *Rapport de la Commission d'Etude sur l'Integrité du Territoire du Québec*, (Québec: 1971).

Economic Council of Canada, *Newfoundland: From Dependency to Self-Reliance* (Ottawa: Supply and Services Canada 1980).

Fullerton, Douglas, "Quebec, Labrador and Newfoundland," *Forces: Revue de documentation économiques, sociale et culturelle*, (No. 57-58, 1981-1982), pp. 44-51.

Hydro-Quebec, *Annual Report 2003: The Power of Change.*

Royal Commission on Renewing and Strengthening Our Place in Canada, *Main Report*, (St. John's: Office of the Queen's Printer 2003).

Schull, Joseph, *The Great Scot: a biography of Donald Gordon* (Montreal: McGill-Queen's University Press 1979).

Smith, Philip, *Brinco: The Story of Churchill Falls* (Toronto: McClelland & Stewart 1975).

*Statutes of Newfoundland*, 1966-67 to 1969, various volumes (St. John's: Queen's Printer).

**APPENDIX I**

Reproduction of C.T. Manning's Handwritten Notes of February 26, 1968

---

*Correspondence* *(1.)*
*CTM*

*Renewal*
*CFLCo/HQ - Power Contract*

*26-2.68*

*Problem :* - *How can the term of the Power Contract be extended either directly or by option to HQ by an additional 10 to 25 years or a fixed mill rate?*
- *The function of such an arrangement to permit HQ to average out a power price that would render the arrangement so attractive as to avoid criticism from proponents of the long term advantages of nuclear power.*
- *The position in Nfld.*

***The Water Power Lease***

*Term & Renewal* - *Lease is for a term of 99 years from 16 May '61 (Clause 1 of Part I)*
- *Lease is subject to Renewal for a further 99 year term. (Part III Clause 2)*

*Public Utilities Act* - *Sec. 4 of 1966-67 Act exempts the supply of power developed under lease to HQ from Public Utilities Act.*

*Power Contract* *Clause 2 A(1)(b) - Def. Of Power Contract:*
- *1st contract executed with HQ.*
- *Excludes any renewal of the contract - or the renewal of the term prescribed therein*
- *"And the said term is expected to be about 40 years"*

*Term of Tax Rebate Arrangement* *2A (2) "during the term of the Power Contract"*

*Conclusion* *(1) if the term is to be significantly longer or shorter than 40 years the lease should be amended to delete above quoted* ***phrase*** *the 40 years.*
*(2) if the extension is to be by option to extend the term then the lease as presently worded would probably not convey any tax rebate benefit in respect of the additional term.*

<u>*Observation*</u> - *it may be that the option approach is the right one provided the price during the extension period is on a formula basis so that (a) if the rebate arrangement* ***cannot*** *be continued the loss to CFLCo is paid for by HQ and (b) replacements of plant and equipment forming part of the project are fully amortized over the extension time without prejudicing an agreed return to the equity.*

*#*

***<u>The Draft Contract Provisions</u>***

*- 40 year term established on basis of the reasonable foreseeable life of the plant without major capital replacements.*
*- if this is to be lengthened then there should be an engineering study made of what components have a life expectancy of 50 - or 60 years as may be agreed and what components would have to be replaced or substantially repaired.*
*- with this data and a return to equity concept, it should be possible to project a flat mill rate on*
*todays costs ---> with escalator for loss of rebate and additional capital costs. - We would also have to consider an escalator in operating costs and whether or not this risk would be too great to accept without an escalator.*
*- Effect of 8% rental. - on mill rate*
*- H.P. Tax -*

<u>*Defeats purpose*</u>

---

Notes:
1. All items in italics correspond to the hand-written notes and symbols.
2. Bolded italicized words are ones which the handwriting was not clear enough to determine the word accurately.

## APPENDIX II

Reproduction of C.T. Manning's Handwritten Notes of March 1, 1968

===

*Extension* - *[Query Renew for a lesser amount of Power at a reduced Rate ]*

*We can see desirability of a fixed price .*

*- Practical & Political considerations*

*Practical - ? operating cots - Escalation*

*rates of wages What will it be in 2012 (?)*

*- Replacements in 40 years - Life of components have to be taken into account.*

*- Tax rebate arrangements - end in 40 years*

*- Boyd thinks it should be in the contract - we are reluctant to open with Nfld. - very tricky*

*This is a very* ***material matter.***

*This to Hydro is like the Completion Guarantee to CFLCo.*

*- A do or die condition -*

*-DJM We are sympathetic.*

===

Notes:

1. DJM refers to Donald J. McParland.

2. Bolded italicized words are ones which the handwriting was not clear enough to determine the word accurately.