December 13, 2024 - (Vol. VIII, No. 110)

Quebec-Newfoundland MOU sets stage for 'historic' hydro deal

By Warren Lovely

Intro: Quebec and Newfoundland and Labrador have reached a major agreement in principle related to the purchase, distribution and development of hydroelectric power. The two provinces jointly announced a non-binding Memorandum of Understanding (MOU) on Thursday, December 12. The MOU is technically between the two public utilities wholly owned by each province (that is Newfoundland and Labrador Hydro and Hydro-Quebec) and a related entity (Churchill Falls Labrador Corp). The MOU is meant to guide future discussions and stakeholder engagement, including with Indigenous communities. A definitive agreement is expected to take a year or more to finalize.

Variously heralded as "A New Energy Partnership" or "An Important Step Towards Securing Quebec's Energy Future", the detailed MOU (which runs to 32 pages) sets the stage for a genuinely historic agreement between two provinces where relations have at times been fractious. In all, the MOU would ultimately cover nearly 9,200 MW of hydro power—the clear majority of which would be purchased by Hydro-Quebec.

Vitally, the MOU outlines a replacement for a highly contentious power purchase agreement (PPA) related to the Upper Churchill Falls hydroelectric generation facility. In addition to a renegotiated power purchase contract, the MOU lays out detailed parameters and plans for the co-development of major new hydroelectric generation capacity.

Most immediately, the revised power purchase contract would have meaningful net positive impacts for Newfoundland and Labrador, which has heretofore benefited little from the Upper Churchill Falls deal (as originally signed and subsequently renewed). As outlined, the intended replacement for the current power purchase agreement would place the Newfoundland and Labrador credit on an improved fiscal footing with immediate effect, while ensuring a fair (market-based) return on the province's hydro-related assets over the long-term. This is no small consideration for a relatively older province carrying a proportionately heavy government debt load. Again from Newfoundland and Labrador's perspective, the agreement in principle would open a pathway for meaningful hydro development (absent much risk), increase access to clean energy, deliver jobs and growth during project construction, and secure financial benefits as an equity stakeholder in new projects.

For Quebec, early renegotiation of the Upper Churchill Falls contract, combined with extra payments ($3.5 billion NPV or $4.8 billion current dollars, some unconditional, some subject) and the acceptance of certain new project risks, would guarantee access to significant hydro capacity long-term. Certain access to cost-effective clean power is a critical element of Hydro-Quebec's strategic plan and the province's overall economic strategy. For Hydro-Quebec, the blended cost of the power covered by MOU would be roughly half the comparable rate for alternative renewable sources. That makes securing this power from Labrador an obvious priority.

A two-fold agreement in principle: The non-binding MOU, which must be converted into a definitive agreement and ultimately approved, has two main component parts.

(1) Early termination of existing Upper Churchill Falls power purchase contract, to be replaced by a new (and fairer) 51-year deal retroactive to 2025 and extending through 2075.

This element lies at the heart of the new MOU. Essentially, the two provinces have agreed to renegotiate a power purchase contract that legally could have held until 2041. The power being purchased here relates to the existing Upper Churchill Falls mega-hydroelectric generation facility (where current installed capacity is ~5,400 MW).

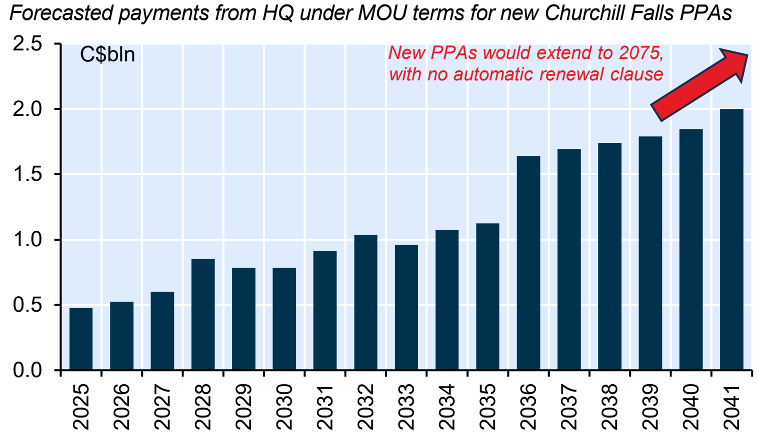
By way of background, the original power purchase contract was signed in 1969. While the deal covered an initial 40-year period, it automatically renewed in 2016 for a further 25 years (i.e., to 2041). This controversial contract has permitted Hydro-Quebec to purchase the vast majority (roughly 90%) of Upper Churchill Falls power for 0.2 cents per kilowatt-hour—a mere fraction of what Hydro-Quebec has been able to resell the power for. So the financial benefits of the power purchase agreement have thus far skewed heavily in Hydro-Quebec's favour.

The perceived inequity of the existing deal had prompted high-profile legal challenges in the past. As recently as 2018, the Supreme Court held that Quebec was not obligated to re-open the deal. Whereas the courts have upheld Quebec's rights under the deal, the imbalanced nature of the agreement has long been a source of intense bitterness on The Rock. As a major irritant to Quebec-Newfoundland relations, continuation of the existing arrangement likely would have compromised the ability to partner on a go-forward basis.

To that end, the two provinces propose terminating the existing PPA. In its place would be a new, fairer deal. As per the MOU, and retroactive to January 1, 2025, the average price paid by Hydro-Quebec for Upper Churchill Falls power would increase 30-fold to 5.9 cents per kilowatt-hour. Additionally, a market-based price escalator would ensure fairness for the life of the new 51-year deal (i.e., through 2075). Of note, there is no automatic renewal mechanism in the proposed deal.

Chart 1: New, fairer PPA addresses long-time irritant

Forecasted payments from HQ under MOU terms for new Churchill Falls PPAs



Source: NBC, N&L, HQ | Note: Payments currently ~$20mln/year; payments forecast to surpass $3bln/year by 2050, surpass $5bln/yr by 2058 and surpass $8bln/year by 2074

The net benefit to Newfoundland and Labrador would clearly be substantial. Under the revised parameters, it is estimated that revenue would average $1 billion per year as opposed to the less than $20 million/year the province would have received if the old arrangement remained in place through 2041. For context, the average annual net benefit would be equivalent to ~$1,800 per citizen given Newfoundland and Labrador's current population of 545,000.

For Hydro-Quebec, the proposed power purchase arrangement would obviously increase the cost of Upper Churchill Falls power vs. the status quo. A partial mitigation strategy involving the re-distribution of dividends would aim to limit the impact on customers to 4 cents/kWh (in current dollars). Since Hydro-Quebec pays dividends to Quebec, there would appear to be some net negative impact on provincial revenue (although this has not been publicly communicated to our knowledge).

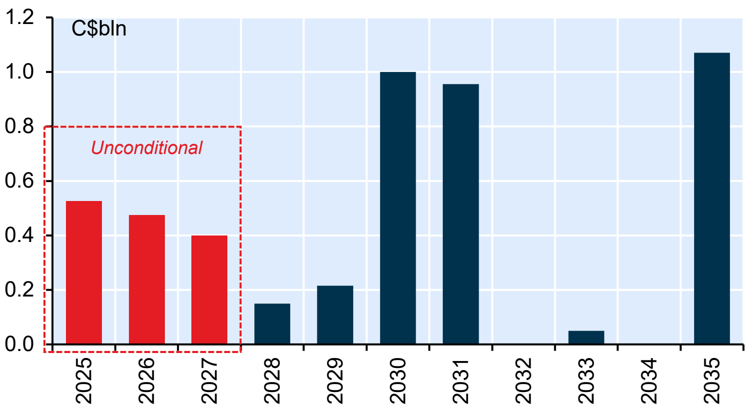
Importantly, the new power purchase agreement is only one part of the MOU. In a sense, replacing the Upper Churchill Falls contract may be seen as the necessary precondition for the second part of the strategy, that of large-scale hydro development in Labrador. Whereas a re-jigged PPA for the existing Churchill Falls facility is essentially a zero-sum game or a case of re-distributing revenue between parties more equitably, the development of net new capacity is meant to be just that: new. As in, new power… made possible by new investment… creating new jobs, new economic growth and new financial benefits… all structured under a new and mutually beneficial contract that both Quebec and Newfoundland and Labrador deem fair.

(2) Co-development of 3,900 MW of net new hydro capacity at Gull Island and Churchill Falls, pursuant to $3.5 billion (current dollars) in payments by Hydro-Quebec.

Hydro-Quebec is prepared to pay Newfoundland and Labrador Hydro (NL Hydro) the equivalent of $3.5 billion (net present value) for the right to co-develop projects with a combined capacity of 3,900 MW and an estimated combined cost of $33 billion. Note that this $3.5 billion would cover Newfoundland and Labrador's equity in the new projects.

Chart 2: $3.5bln (NPV) payments as part of new development

Forecasted payments from Hydro-Quebec to Newfoundland and Labrador Hydro



Source: NBC, N&L, HQ | Note: 2028-35 installments conditional on project milestones

Of this amount, $1.3 billion would flow over the first three years unconditionally. The balance of $2.2 billion (NPV) would be paid via conditional installments from 2028 to 2035, subject to milestones on the largest development projects.

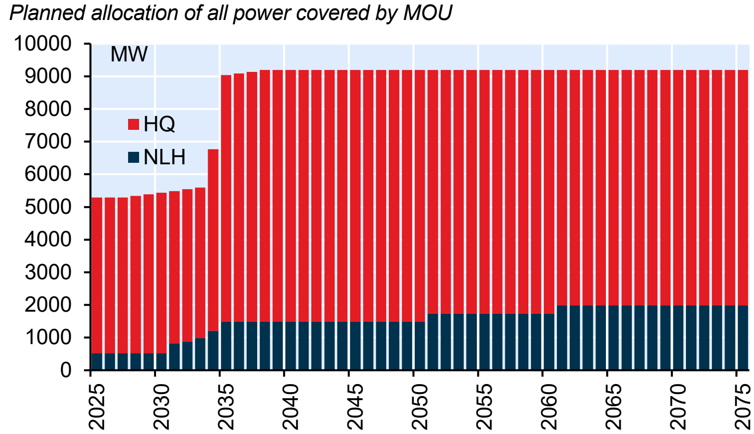
Complete details are set out in the detailed MOU, but the following summarizes the major new project elements being contemplated:

- **Gull Island (New Development)** – This new project is expected to generate 2,250 MW of power. Hydro-Quebec would be responsible for the design, construction and financing of this megaproject, although it would ultimately be operated by NL Hydro. Construction risks and cost overruns would be borne by HQ. The intended capital structure would be 25% equity, 75% debt. Once online, Hydro-Quebec would take no less than 90% of the power pursuant to a PPA (which would be structured on a cost-plus basis).
- **Upper Churchills Falls (Expansion)** – A planned expansion at the Upper Churchill Falls site is expected to create 1,100 MW of new capacity. As with Gull Island, Hydro-Quebec would design and build, likewise bearing full responsibility for construction risks and cost overruns. This project would be debt financed, with 25% deemed equity, where 8-9% returns on equity are stipulated.
- **Upper Churchills Falls (Modernization)** – Enhancement of the existing Churchill Falls facility would add an additional 550 MW of net new power (boosting total rated capacity to nearly 6,000 MW). A related power purchase agreement would be designed on a cost-plus basis. NL Hydro would be fully responsible for this upgrade project, which is expected to be fully debt financed.
- **Transmission (Incremental)** – More transmission capacity would be needed to accommodate the 3,900 MW of newly developed power envisioned by the MOU. Each utility would be responsible for requirements in their own jurisdiction. For Newfoundland and Labrador, this would involve new lines from Churchill Falls to Gull Island and from there to the Quebec border. It is expected that the new transmission assets in Labrador would be 75% debt financed. Hydro-Quebec would of course have its own transmission requirements as part of wheeling the power to its final destination.

It is believed work could start as early as 2028, the first step naturally being upgrades at the existing Upper Churchill Falls facility. It is estimated that construction of these major projects could support thousands of jobs over a generation. Incentives in the MOU aim to encourage full and timely completion, including the conditional payments from 2028 to 2035 previously outlined and power rights.

Chart 3: This is what energy security is meant to look like

Planned allocation of all power covered by MOU



Source: NBC, N&L, HQ | Note: Incorporates existing CF facility + planned developments

For Hydro-Quebec, the average price of power to come online via these new developments is estimated at 11 cents/kWh. That is below the average generation cost set out in the utility's long-term strategic plan (13 cents/kWh). When blended with the net cost associated with the proposed revision of the Upper Churchill Falls agreement, the average cost of all power arriving from Labrador (more than 7,000 MW) would be 6 cents/kWh. For comparison purposes, that is considered to be roughly half the cost of available clean energy alternatives in North America. In an effort to preserve affordability and relative competitiveness, Hydro-Quebec has pledged to cap residential rate increases at 3%, with commercial and industrial rate increases to be limited to 4-5%. It is believed that this agreement in principle would help the utility respect these important commitments.

Bottom Line (for N&L): As set out in the MOU, the net incremental benefit that could accrue to Newfoundland and Labrador looks both significant and timely. For this province, the early termination of an imbalanced power purchase agreement—to be replaced by a more equitable arrangement—would deliver significant net new revenue.

Accounting for planned capacity increases and power rights sharing, Newfoundland and Labrador would itself have access to considerably more clean energy. As per the MOU, the province would have access to 1,990 MW (out of the total 9,190 MW covered here) or roughly four-times current levels. That could help foster industrial development in the province. The cost of new megaproject development is prohibitive for a province this size, so co-development with Hydro-Quebec aids feasibility. Risks related to construction and cost overruns on the largest projects being planned would be the responsibility of HQ, which it should be noted has considerable expertise when it comes to developing such facilities. This transfer to risk to an entity with relatively greater expertise is no trivial matter for NL Hydro and its provincial guarantor, given the lengthy delays and material cost overruns that characterized an earlier megaproject in Labrador. While partly conditional, Hydro-Quebec's $3.5 billion in scheduled payments (NPV) would also cover Newfoundland's equity stake in these key projects. Moreover, the sheer magnitude of work involved would provide a significant boost to the local economy during the construction phase.

To be clear, there is new debt contemplated by this MOU, which Newfoundland and Labrador indicates would likely take the form of non-recourse project debt (and thus presumably be off the province's balance sheet). At this point, no federal guarantee is being contemplated for project-related debt. Expect additional details once a definitive agreement is reached and construction nears.

All told, the long-term revenue impacts envisioned here (estimated at $225 billion over the life of the 50-year deal) would better ensure competitive hydro rates in Newfoundland and Labrador, provide welcome debt relief, while simultaneously encouraging economic development and buoying long-term fiscal sustainability. If ultimately approved, the type of deal outlined in the MOU would be clearly credit positive for Newfoundland and Labrador (and its explicitly guaranteed utility), with spreads on the province's debt not surprisingly well-supported as news of the deal circulated.

As is relates to the province's near-term borrowing requirements, we do not envision a material change. Note the Newfoundland and Labrador is comfortably positioned against its 2024-25 bond program. Prior to the MOU, there was only $300 million of term financing needed before March 31st (i.e., the equivalent of single domestic benchmark transaction). A final agreement will take time to formalize, while the intended retroactive nature of certain provisions could have cash-timing implications down the road. Regardless, the favourable combination of positive headline news and a muted near-term supply outlook helps to explain the roughly 5 basis point tightening in Newfoundland and Labrador's 30-year basis to Ontario on a week-over-week basis.

Bottom Line (for Quebec): This looks to be a case of giving something to get something. An Upper Churchill Falls power purchase agreement that has delivered disproportionate revenue for decades would be reset on more level terms. As noted, Hydro-Quebec dividends, which ultimately accrue to Quebec, would need to be diverted to cushion the impact on customers. There are also the intended payments (partly unconditional) which cover Newfoundland's equity stake in the new developments, alongside potential construction costs/risks (which Hydro-Quebec admittedly looks very adept at handling).

But in return, Quebec would guarantee itself access to some 7,200 MW of clean power over the long run. This power is needed and looks to be secured at what could objectively be deemed cost-effective rates when compared to the alternatives readily on offer. Energy security has value and Quebec is hardly the only jurisdiction to recognize this. Moreover, for a province legitimately focused on decarbonization and sustainable long-term growth, the clean energy projects in focus here (both existing and planned) are the most natural fit. So while the modest pressure on Quebec's relative bond spreads is perhaps understandable, here is a province prepared to move forward on a transformative long-term strategic vision.

As for Quebec-related borrowings, there appear to be no immediate implications. The province had already begun to pre-fund towards its 2025-26 requirement and does not intend to issue for the remainder of the calendar year. Hydro-Quebec, which operates on a calendar year basis, had an underlying requirement of $5 billion for 2025, with a portion (roughly $1 billion pre-funded in the outgoing calendar year). We do not anticipate a significant change in near-term funding requirements related to this agreement in principle.

Note: At time of publishing, we were note aware of any formal comment by any credit rating agencies. As a reminder, both Hydro-Quebec and NL Hydro are explicitly guaranteed by their home province (Newfoundland and Labrador and Quebec respectively).

Finally, the non-binding MOU will now be the subject of additional negotiations and consultations, with this process expected to take a year or more to complete. This process will include further consultation with Indigenous stakeholders. At the unveiling of the MOU, the Grand Chief of the Innu Nation demonstrated support for the agreement in principle, given related protections and planned inclusions for the Innu of Labrador. The obvious goal of the proponents is to reach a definitive agreement. In the meantime, the existing power purchase agreement related to Upper Churchill Falls remains in effect.

Select links:

Official Memorandum of Understanding (MOU) dated 12-Dec-24:

- https://www.ourchapter.ca/files/Compiled-Project-Winston-Ion-Memorandum-of-Understanding-Execution-Version.pdf

Newfoundland and Labrador official news release:

- *https://www.gov.nl.ca/releases/2024/exec/1212n02/*

Newfoundland and Labrador "Our Chapter" dedicated site:

- https://www.ourchapter.ca/

Hydro-Quebec official news release:

- https://news.hydroquebec.com/en/press-releases/2143/an-important-step-towards-securing-quebecs-energy-future/

Hydro-Quebec Action Plan 2035:

- https://www.hydroquebec.com/about/publications-reports/action-plan-2035.html

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