

# THE CHURCHILL FALLS CONTRACT AND WHY NEWFOUNDLANDERS CAN'T GET OVER IT



James P. Feehan and Melvin Baker

In June 2010, Newfoundland Premier Danny Williams, in a speech to the Canadian Club in Ottawa, launched a verbal assault on Quebec. Angered by the recent ruling by Quebec's Régie de l'énergie, a ruling that dealt with the use of Hydro-Québec's grid to wheel electricity from a potential Lower Churchill River development, he argued the ruling was biased and unfair. He then proceeded to a broader list of grievances and frustrations with Quebec. The Churchill Falls contract, now some 41 years old, made the list. The authors explain why grievances over that contract will only worsen in the future.

C'est sans ménagement que le premier ministre de Terre-Neuve-et-Labrador Danny Williams a fustigé le Québec en juin dernier à l'occasion d'un discours prononcé au Canadian Club d'Ottawa. L'objet de sa colère : la décision « injuste et partielle » que venait de rendre la Régie de l'énergie du Québec sur l'utilisation du réseau d'Hydro-Québec pour transporter l'électricité nécessaire à l'aménagement du cours inférieur de la rivière Churchill. Puis il a étoffé sa diatribe d'autres récriminations, notamment au sujet du contrat de Churchill Falls. Les auteurs expliquent pourquoi les doléances relatives à ce contrat vieux de 41 ans n'iront qu'en s'aggravant.

The 1969 power contract between Hydro-Quebec and the Churchill Falls Labrador Corporation (CFLCo) has been a matter of enduring resentment in Newfoundland and Labrador. The contract concerns the development and subsequent sale of electricity from the Churchill Falls hydro site, one of the world's largest. Almost all the power must be sold to Hydro-Québec on a very long-term basis at an extremely low price.

Since the mid-1970s the government of Newfoundland has challenged this contract in a number of ways. It has made appeals to Canadian public opinion; it has made requests to the Quebec authorities to renegotiate the contract; and it has called on the federal government to assist in finding a resolution. In the 1980s, the Supreme Court of Canada heard two appeals arising from actions launched by the Newfoundland government: one to gain access to a larger portion of the energy and the other to test the validity of nullifying the contract by legislative action. Both challenges failed and none of the other tactics has been successful either.

The perceived injustice of the contract resonates in Newfoundland political culture, being characterized as another case where the province's resources have been

exploited by outsiders. Still, Canadians generally and especially Quebeckers are no doubt weary of on-going complaints about the contract. It has been approximately 40 years since the contract was signed. 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. However, the contract provides for automatic renewal at the expiry date for a further 25-year period with the arrangements predetermined. As such, it amounts to a contract "piggybacked" onto a contract. During the renewal period the price is preset at \$2 per megawatt hour (MWh). Even in the late 1960s, a price of \$2 was extraordinarily low and not achievable from any new energy source then available to Hydro-Québec. To put this future price in perspective, in 2004 the average wholesale price of electricity in Ontario was about \$52 per MWh, and in 2003 Hydro-Québec received an average of approximately \$85 per MWh for its electricity exports. A price of \$2 in 2016 with that price fixed until 2041 is barely distinguishable from being free. The amount of electricity involved is approximately 30 million

MWh annually. Thus, the gap between the revenue that CFLCo would receive during renewal and the wholesale value of the electricity could amount to billions of dollars per year for 25 years. In fact, with revenues of \$60 million annually during the life of the renewal contract, it is unlikely that CFLCo will cover its operating costs, making it necessary for it to cross-subsidize the arrangement with revenues from other sources.

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These future prospects keep Newfoundlanders from putting the issue behind them. On top of that, there is the process that led to this extraordinary renewal arrangement. The focus of this article is to explain the latter while putting it in the context of the overall negotiations.

The 1969 contract was the culmination of many years of negotiations between its two signatories, Hydro-Québec and CFLCo. CFLCo was originally named the Hamilton Falls Power Corporation, a private corporation created in 1958 by Brinco, the British Newfoundland Corporation. Brinco itself was founded by British industrialists whose investment in Newfoundland had been sought by Premier J.R. Smallwood in the 1950s. Initially, Brinco took an 80 percent interest in CFLCo, and, upon Brinco's invitation, the Shawinigan Engineering Company of Montreal took 20 percent. CFLCo's purpose was the development of the hydroelectric potential of the Churchill Falls in the Labrador region of Newfoundland. Today, CFLCo is 65.8 percent owned by the publicly owned Newfoundland and Labrador Hydro Corporation and 34.2 percent by Hydro-Québec. In 1974, the provincial

government purchased Brinco's shares in CFLCo as well as its water rights to the sites on the Lower Churchill River.

Negotiations between the two parties began in the early 1960s and followed many ups and downs, complicated by political relations between the premiers of the two provinces. Hydro-Québec had to obtain Quebec government approval for any deal, and the Newfoundland govern-

ment was the leaser of the water rights. The major political spats that arose involved two issues. First, there was the inland boundary between Quebec and Labrador. A dispute between Canada and Newfoundland over the location of this boundary was settled by a ruling of the Judicial Committee of Britain's Privy Council in 1927. The ruling caused lingering resentment in Quebec and, at times and to the annoyance of Smallwood, Quebec Premier Jean Lesage attempted to tie the commercial agreement to a political agreement to change the boundary. Second, there was the matter of the ownership of CFLCo. In the early 1960s, as part of its nationalization of private electricity generators, the Quebec government nationalized the 20 percent interest held in CFLCo by Shawinigan Engineering. This caused a bitter reaction by Smallwood, and was eventually solved by some Brinco concessions, including allowing Newfoundland to take a small equity position in CFLCo.

Aside from the political fallout, Hydro-Québec's participation in CFLCo raised the matter of a potential conflict of interest. Robert Winters, president of Brinco, raised this issue with Hydro-Québec President J.C. Lessard. According to his records, when he met with Lessard on July 2, 1963:

*I suggested to Mr. Lessard that he might wish to seek legal advice as to whether or not there is likely to be a substantial conflict of interest with him being at the same time a representative of the buyer and the seller of power.*

Also, in August 1963, Winters cautioned Lesage that a conflict of interest might arise if Hydro-Québec were to be on the board of CFLCo while negotiating with it and offered to buy back the shares at a substantial premium. Lesage refused the offer, and Lessard became a member of the board of directors of CFLCo.

Nevertheless, commercial negotiations began in earnest in the fall of 1963.

Prompted by interest from Hydro-Québec, CFLCo developed a proposal for a power-purchase agreement based on a 30-year term. The proposal document, dated September 1963, also contained the following renewal provision:

*Both HFPCo and Hydro-Québec 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.*

This was far removed from the one that appeared in the final contract.

Over the next three years, negotiations followed a roller-coaster ride. Harsh words exchanged at the political level over the issues listed earlier complicated the negotiations. Still, progress on commercial terms was made. Throughout, renewal was not a matter of dispute. Every draft proposal and, later, every draft letter of intent contained a renewal clause consistent with the one quoted above.

By the autumn of 1966, the parties had agreed on a 21-page letter of intent agreement. Hydro-Québec officials signed it on October 13, 1966, as did representatives of CFLCo. The letter, which provided that Hydro-Québec would be



Photo courtesy CFLCo

The fateful signing ceremony for the Churchill Falls contract in 1969. Seated second from left is Jean-Claude Lessard, president of Hydro-Québec, and looking over his shoulder, standing at left, is Robert Boyd, future president of Hydro-Québec and builder of the James Bay hydro project in the 1970s. Seated second from right is Donald McParland, president of the Churchill Falls Labrador Corp., and between them, looking on, is Henry Borden, board chairman of Brinco.

entitled to purchase almost all the energy on a take-or-pay basis, was apparently quite satisfactory to both sides. Certainly, Hydro-Québec was happy with the terms. Its general manager, Robert Boyd, in a letter dated September 22, 1966, to Hydro-Québec's commissioners, pointed out that the cost was lower than any other source, including nuclear, that Hydro-Québec could undertake. Toward the conclusion of that letter, he wrote:

*The purchase of energy from Churchill Falls would act as a life raft which would allow Hydro-Québec to safely navigate the rough waters of system growth which lie ahead.*

Hydro-Québec's Lessard, at a press conference held on the day of the signing, stated:

*Hydro-Québec has succeeded in obtaining, at an opportune moment, the most favourable agreement possible.*

The letter of intent itself was characterized by an essential quid pro quo. Following a particularly serious breakdown in negotiations, CFLCo agreed to move its price even lower and to a much longer term, 44 years rather than 30 to 35. Such concessions, because they reduce the scope for profit, would make it more difficult to raise funds to finance such a project. However, on the other hand, Hydro-Québec agreed to assume or share some of the project risks. In particular, Hydro-Québec agreed to guarantee or provide loans for additional funds, up to a limit of \$109 million, if the project's capital cost exceeded the anticipated amount and CFLCo could not obtain those funds from other sources. This commitment, originally suggested by Lesage, was later to be known as the completion guarantee. The low-price regime had been facilitated by Smallwood, who had lobbied the federal government to increase its rebate to provincial governments of federal cor-

porate income tax paid by public utilities; Newfoundland would give CFLCo the increased rebate of CFLCo's federal tax payments in order to allow it to lower the price to Hydro-Québec. Newfoundland also amended the water-rights lease to shield CFLCo from any new provincial taxes or tax increases during the term.

As for renewal, the agreement provided:

*Hydro-Québec 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.*

Thus, this element of the deal continued to reflect what had been agreed from the start. However, it was weakened in the sense that the opportunity to negotiate new conditions was now to be delayed as a result of the much longer term for the initial contract.



Within 30 days of signing the letter of intent, CFLCo had recalled workers to the construction site. (Some work had been completed earlier during times when agreements looked imminent.) Before year's end, the company also began work on structuring the definitive power contract based on the letter of intent. By March 1967 CFLCo envisaged a schedule that would lead to a power contract by October 31 of that year. In anticipation of that contract CFLCo embarked on an extensive and expensive construction program to meet Hydro-Québec's requirement that the first power be available in 1972.

By mid-1967, CFLCo realized that the pace of negotiations was such that the contract would not be finalized as soon as expected. Without this, major financing for the several years of construction could not be arranged until around June 1968. In the interim, funds would be needed. Therefore CFLCo planned a public offering of shares to raise funds to finance its expenditures to the spring of 1968. With a contract likely to be nearly in place or agreed by then, it could rely on bank loans until major financing was arranged over the subsequent months.

However, by the fall of 1967, market conditions precluded the public offering and the shares had to be taken up by CFLCo's shareholders, which by then were Brinco, Hydro-Québec, Newfoundland and Rio Algom, a corporate ally of Brinco. This arrangement forced Brinco to borrow heavily, placing a substantial and unanticipated financial burden on it. Thereafter, it was no longer in a position to come to CFLCo's financial aid.

Nevertheless, progress on finalizing the contract was steady, if slow. No substantive disagreements had arisen and the political sensitivities had petered out. A first draft contract, dated September 19, had been exchanged. That was followed by an October 6 draft. Both contained a

renewal clause, which was consistent with the original meaning of the 1963 proposal as well as the 1966 letter of intent and all the discussions to date.

Negotiations progressed and several more drafts followed in October, November and December. Following concerted efforts, CFLCo prepared a comprehensive draft dated January 15, 1968. On February 13 there was a CFLCo board meeting. The minutes report that among the directors present was Hydro-Québec's Lessard. The directors were told that it was hoped, following imminent negotiations based on the January 15 draft, there would be an agreement "in the near future." Lessard asked if the January 15 draft was CFLCo's "maximum conditions," to which the chair-

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man responded that the draft represented the conditions that financial advisers believed investors required. At the meeting, the directors were also updated on CFLCo's financial condition. It had only enough funds to last about another two or three months, but if by then the contract was agreed, then further financing could be arranged.

Before the end of February, Hydro-Québec developed a redraft of the January 15 draft. This version introduced new elements to the completion guarantee, which by then no longer had a limit. Now, if the guarantee were ever to be triggered, then new shares in CFLCo would be attached to any loans made to it by Hydro-Québec. Still, the substance of the

renewal provision remained intact. Its key passage was:

*Hydro-Québec 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.*

When the negotiating teams met on March 1, 1968, Hydro-Québec sought a radically different arrangement: 25 years at a fixed price of \$2.20 per MWh. The CFLCo side was reluctant, raising the issues of wage escalation and the need for plant replacement so far into the future and pointing out that various provincial tax concessions and the federal tax rebate arrangement would end with the contract's term.

Later in March, CFLCo negotiators sought compromises on the new renewal demand. However, those efforts were to no avail. From mid-March to mid-April, events moved quickly in terms of both the contract and the major financial plan, with Hydro-Québec also becoming extensively involved in the latter.

The next full draft of the contract was dated April 19. It contained several CFLCo concessions relative to the February 18 version. One concession was the replacement of the renewal clause. It now provided for automatic renewal, without signatures being required, with practically all the energy to be sold to Hydro-Québec at \$2 per MWh for 25 years; even in the context of 1968 that price was extraordinarily cheap. CFLCo, which by then would have almost fully exhausted its finances, acquiesced to this and other concessions.

Further drafts of the contract followed but the changes were not substantial. In effect, before the end of April, meaningful negotiations had ended. Financial arrangements with Hydro-Québec had also been settled in April. They required substantial undertakings by Brinco and CFLCo and provided Hydro-Québec

with the opportunity to take an even larger ownership position in CFLCo, 25.7 percent. In addition, Hydro-Québec's involvement in the subsequent financing allowed it to increase its ownership position to 34.2 percent by 1969. Moreover, the completion guarantee and other provisions in the contract now provided for new free shares in CFLCo if it were to need loans from Hydro-Québec; the availability of such

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loans had been agreed to much earlier but the added compensation of free shares was a new element.

In June of 1968 Hydro-Québec's commissioners approved the contract together with related financial arrangements, and Québec government authorization followed in July. On June 13, the members of the CFLCo board of directors, including Lessard, all voted to approve the deal. Around this time, according to Philip Smith in his 1975 tome *Brinco: The Story of Churchill Falls*, CFLCo was sending staff with signing authority out of the office in order to have an excuse not to pay its bills. Also, in July of 1968, Brinco entered into a voting trust agreement with Hydro-Québec, which allowed Hydro-Québec to gain control of CFLCo and possibly majority ownership if CFLCo could not carry through with financing and other actions within a specific time period. This meant that there could be no going back to meaningful negotiations for CFLCo. It was locked in.

In short, while the contract was not signed until May of 1969, its contents were determined by May of 1968. Thus, there was only a short period between Hydro-Québec's demand and CFLCo's concession on the renewal clause.

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did the two signatories to the contract make of the renewal clause at the time? And what did the Newfoundland government make of this arrangement?

The Quebec side certainly understood the implications of the new renewal clause. In a letter dated June 6, 1968, to Quebec Premier Daniel Johnson, Lessard presented a synopsis of the main considerations that justified acceptance of the draft contract. One of the considerations was the renewal clause.

Several supporting documents were enclosed with Lessard's letter, including a report that demonstrated that, for 1972 to 2015, Churchill Falls was the best of the alternatives available to Hydro-Québec. Regarding the new renewal clause, it added (note that 2.0 mills per kilowatt hour is equivalent to \$2 per MWh)

*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 million per year for the 25 years, or \$725 million.*

The report did not speculate on how large that cost difference might be by 2016 and thereafter. However, a difference of just 8 mills per kWh, \$8 per MWh, would translate into almost a quarter of a billion dollars per year to

Hydro-Québec's advantage. (And the difference is now much greater.) In any case, with the renewal price fixed at \$2 per MWh, Hydro-Québec knew that none of any increase in the value of the energy would accrue to CFLCo.

Another document was a comparison of the draft contract with the 1966 letter of intent. Regarding renewal, it stated:

*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.*

Thus, Hydro-Québec understood that the price of \$2 was very low even for 1968, and by the time it would come into effect, inflation would have eroded it substantially.

What were CFLCo's anticipations? It did not have to prepare any submission for Newfoundland government approval and it appears that CFLCo did not make financial projections beyond 2016, when the contract term expires. However, based on its numbers, if inflation was anything more than 4 percent, then operating costs alone would exceed revenues during the renewal period. CFLCo well understood that problem as well as the other reasons to expect no chance of profit. As CFLCo pointed out at the March 1 meeting, 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. Additionally, various tax exemptions, as well as protection from tax increases and new taxes that had been provided by the provincial government, did not extend

to the renewal period. Also, the province's commitment to turn over the increase in the federal tax rebate did not extend to the renewal period, so CFLCo would be subject to the full federal corporate income tax rate, in the unlikely event that it made any profit under the renewal contract.

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Hence, CFLCo would have had little reason to expect any positive return during the renewal period. In acquiescing to Hydro-Québec, CFLCo's management would have understood that it was placing CFLCo in a position such that during the 25-year renewal period it would likely suffer losses or, at best, insignificant and capped earnings. Without a future amendment to the 25-year renewal clause, CFLCo would have understood at the time that it had no prospect whatsoever to share in any increase in the market value of its energy sales to Hydro-Québec. The latter was assured of all the associated economic rent in the renewal period. The fact that they accepted this prospect attests to CFLCo's and Brinco's assessment of the situation, not to a failure to understand the implications. The demand to replace the renewal clause had come when CFLCo was close to exhausting its cash, when Brinco was in no position to help (and was itself in need of a rescue plan) and when interim bank financing was dependent on CFLCo demonstrating that an agreement was at hand. And only an announcement from the Quebec side that there was an agreement would satisfy the banks.

Even more telling is the remark found in the handwritten notes made by one of CFLCo's representatives at the negotiating meeting where Hydro-Québec first demanded the change to the renewal provision. When that demand was advanced, CFLCo vice-president C.T. Manning wrote, "A do or die condition."

CFLCo understood the severe implications of the renewal clause but chose not to die.

The first that Smallwood was to learn of the new renewal terms was on July 12, 1968, via a telephone call from Donald Gordon, the CFLCo board chairman. That was the same day that Hydro-Québec issued its press release announcing the deal; that release highlighted the renewal terms. Gordon kept

a record of his telephone conversation with Smallwood. Gordon started by informing him that the Quebec government had authorized Hydro-Québec to proceed with the agreement with CFLCo. Smallwood then offered congratulations and inquired as to when the actual signing would take place. The chairman responded that it depended on finalization of the major financing. Only at the end of the conversation did Gordon bring up the renewal clause. To quote from his record:

*I said there was one special point mentioned in the Hydro Québec 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.*

Smallwood's reaction that two mills was "pretty cheap power" shows that he had some appreciation of the implications. However, this appears to have been the extent of any Newfoundland assessment at the time. In any case, by the time Smallwood was informed, the contract was a fait accompli and the Newfoundland government's approval was not required by CFLCo to sign the deal. It is conceivable that Smallwood might have been able to interfere in the arrangements for major financing, for instance, by not passing subsequent legislation clarifying CFLCo's rights to mortgage its assets. However, under the voting trust agreement between Hydro-Québec and Brinco, if CFLCo failed to arrange the major financing by December 15, 1968, then Hydro-Québec was entitled to take a controlling interest in

CFLCo. Therefore, such action by Smallwood — and there is no evidence that he ever considered it — would not have protected his province's interests.

As far as the two contracting parties were concerned, both understood the implications of the renewal clause at the time. Hydro-Québec recognized that \$2 per MWh was an extremely advantageous price even in 1968 and that it was below the cost of any existing alternatives. CFLCo's management understood the perils of agreeing to such a low fixed price so far into the future with no safeguards.

The severity of that bargain, combined with the conflict-of-interest considerations and Hydro-Québec's apparent lack of concern for a corporate entity in which it had a significant ownership position, raises some substantial issues. First, one may ask what were the norms of corporate governance and business ethics at the time and whether in this case those norms were adhered to. Secondly, the timing of the demand to change the renewal clause — when CFLCo was known to be at its financial limits — raises the question of business ethics again and leads to the question of whether economic duress was at play.

Whatever the answers to these questions may be, the following conclusion is in order. It is inconceivable that any party to a commercial transaction would knowingly and willingly agree today to sell its services some 50 to 75 years in the future at a price fixed below the current price, except if either forced to do or given commensurate compensation; in this case, the latter did not happen. This and the evermore lopsided outcome ensure that most Newfoundlanders will find it impossible to put the Churchill Falls contract behind them.

*James P. Feehan is a professor of economics at Memorial University, where he is editor of the journal Newfoundland and Labrador Studies. feehan@mun.ca Melvin Baker is the university archivist-historian for Memorial University. melbaker@mun.ca Adapted from a more extensive article from the Spring 2007 issue of the Dalhousie Law Journal.*