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James P. Feehan\* and      The Origins of a Coming Crisis:  
Melvin Baker\*\*              Renewal of the Churchill Falls Contract

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*The 1969 Churchill Falls contract between Hydro-Québec and the Churchill Falls Labrador Corporation has been the subject of political controversy. It has also been challenged in the courts, with appeals reaching to the Supreme Court of Canada. Yet, despite the scrutiny of those court cases, the political rhetoric, and the literature that has been spawned by this matter, an extraordinary element of that contract remains remarkably obscure. It is the contract's renewal clause. At the expiry of the contract's forty-four-year term in 2016, that clause requires an automatic renewal for twenty-five additional years at a fixed nominal price that is lower than what prevailed in the 1960s. Since many billions of dollars worth of electricity will be involved, renewal is certain to become a matter of serious dispute, likely involving political and legal dimensions. The authors provide the first systematic investigation of the origins of this renewal provision, based largely on archival sources including hitherto unknown documents, and suggest that the events at issue may raise questions of business ethics and law.*

*Le contrat des chutes Churchill conclu en 1969 entre Hydro-Québec et la Churchill Falls (Labrador) Corporation a suscité une grande controverse politique. Il a aussi été contesté devant les tribunaux, les parties étant même allées jusqu'à soumettre leurs différends à la Cour suprême du Canada. Pourtant, en dépit de l'examen minutieux de ce contrat par les tribunaux dans le cadre des nombreuses poursuites, en dépit de la rhétorique politique et en dépit de toute l'encre qui a coulé, un élément extraordinaire de ce contrat reste mystérieux : la clause de reconduction. Cette disposition prévoit qu'en 2016, à l'expiration des quarante-quatre ans que doit durer le contrat, il sera reconduit d'office pour vingt-cinq années additionnelles, à un tarif nominal fixe inférieur au tarif en vigueur pendant les années 1960. Puisque cette reconduction portera sur des milliards de dollars, il est certain que la reconduction provoquera un différend de taille qui aura vraisemblablement des dimensions politiques et légales. Les auteurs présentent la première étude exhaustive sur les origines de cette clause de reconduction, étude réalisée en grande partie grâce à des documents d'archive et à d'autres documents dont, jusqu'à tout récemment, on ignorait l'existence; ils avancent que les événements relatés pourront soulever des questions quant à l'éthique des affaires et à la loi.*

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\* Professor of Economics, Memorial University, St. John's, NL.

\*\* University Archivist-Historian, Memorial University, St. John's, NL. This paper extends our working paper, J. Feehan and M. Baker, "The Renewal Clause in the Churchill Falls Contract: The Origins of a Coming Crisis," Papers in Political Economy, Paper No. 96, (Political Economy Research Group, University of Western Ontario, 2005). We are grateful to Peter Neary, David Vardy, and two anonymous referees for helpful advice. Any errors are solely the responsibility of the authors.

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*Introduction*

The 1969 power contract between Hydro-Québec and the Churchill Falls (Labrador) Corporation (CFLCo) has been a matter of considerable 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 and Labrador 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.<sup>1</sup> Both challenges, which were opposed by CFLCo as well as Hydro-Québec, failed. 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 its resources have been exploited by outsiders. Few, if any, would disagree with the opinion, expressed in 2003, by the provincial Royal Commission on Renewing and Strengthening Our Place in Canada that the outcome of the contract is inequitable.<sup>2</sup> Still, Canadians generally and especially Quebecers are no doubt weary of on-going complaints about the contract. It has been almost forty 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. The forty-four-year term of the contract runs from 1972 to 2016. However, the contract provides for automatic renewal at the expiry date for a further twenty-five-year period with the terms predetermined. As such, it amounts to a contract “piggy-backed” onto a contract. During the renewal period the price is pre-set at two mills per kilowatt hour. A mill is one-tenth of a cent, so two mills is 0.2 cents. Even in the late 1960s, a price of two mills was extraordinarily low and not achievable from any new energy source then available to Hydro-Québec. To put this price in perspective, in 2004 the average wholesale price of electricity in Ontario was 52.2 mills per kilowatt hour and in 2003 Hydro-Québec received an average of approximately 84.9 mills for its electricity exports.<sup>3</sup> A price of two mills in 2016 with that price fixed until 2041 is barely distinguishable from being free. The amount of electricity involved is approximately 30 billion kilowatt hours (30 million megawatt hours) 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 twenty-five years. Surely, this is the seed for a serious

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1. *Re Upper Churchill Water Rights Reversion Act*, [1984] 1 S.C.R. 297 and *Newfoundland (Attorney-General) v. Churchill Falls (Labrador) Corporation*, [1988] 1 S.C.R. 1085. Both involved arguments by Newfoundland that the water rights lease between it and CFLCo took precedence over the contract.

2. Royal Commission on Renewing and Strengthening Our Place in Canada, *Final Report* (St. John's: Queen's Printer, 2003) at 122-125.

3. 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](http://www.ieso.ca/imoweb/media/md_prices.asp)>. For Hydro-Québec the figure is based on data on p.107 of its 2003 annual report: *The Power of Change* <[http://hydroquebec.com/publications/en/annual\\_report/2003/pdf/hydro2003en\\_complete.pdf](http://hydroquebec.com/publications/en/annual_report/2003/pdf/hydro2003en_complete.pdf)>.

conflict involving the contracting parties and their owners, namely the two provincial governments.

Of course the existence of this provision is not 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. Amazingly, that has not happened. In his nearly 400-page tome on Churchill Falls, Philip Smith offers no meaningful insight, devoting only a single sentence to renewal.<sup>4</sup> The Economic Council of Canada was 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.<sup>5</sup> Even in articles in the special issue of *Forces* devoted to Hydro-Québec's perspectives on the 1969 contract, the renewal clause is barely mentioned.<sup>6</sup> How anyone would agree to, or ask for, a renewal clause like this is an enigma.

This article presents the results of the first systematic investigation of that mysterious clause. To do this, it was necessary to put it in context by giving due consideration to the process that led to the contract. We provide that background by drawing on primary sources, including CFLCo and Hydro-Québec correspondence, memoranda, reports and records; we also rely on hitherto unknown or uncited documents, including ones obtained under freedom-of-information requests. The findings may raise substantive questions of business ethics and law.

This article is organized as follows. Part I gives important background and then reviews the early discussions and the interrelated commercial and political challenges that had to be overcome before the two parties could agree on a comprehensive Letter of Intent. Then, Part II turns to the contract negotiations and the events that specifically led to the renewal clause in its present form. Part III deals with the implications for the three key parties: Hydro-Québec as the buyer, CFLCo as the seller, and Newfoundland as the resource owner. Crucially, those implications are assessed in the context of the late 1960s, not with respect to current and anticipated future electricity prices. Part IV is a brief overview of the events following the end of negotiations and up to recent years.

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4. Philip Smith, *Brinco: The Story of Churchill Falls*, (Toronto: McClelland & Stewart, 1975) at 288.

5. Economic Council of Canada, *Newfoundland: From Dependency to Self-Reliance* (Ottawa: Supply and Services Canada, 1980) at 121.

6. *Forces: Revue de documentation économique, sociale et culturelle* (No. 57-58, 1981-1982). See p.41 and p.99 for references in English; corresponding references are provided in French elsewhere in the same document. None provides any insight into the renewal clause's origins.

### I. *The letter of intent*

The precursor to the 1969 contract was a Letter of Intent that took many years to achieve.

In 1949, Newfoundland became part of Canada, and Joseph Smallwood, a leading proponent of that union, became the first provincial premier. Smallwood, a colourful and controversial political personality, would remain premier until his political defeat in 1971. During his tenure, he sought to industrialize the province's under-developed economy in order to catch up with the rest of Canada.<sup>7</sup> To that end, he sought outside expertise and capital.

Hence, in 1952, in a quest for investors, Smallwood approached leading British bankers and industrialists. That led to the formation of the British Newfoundland Corporation, Brinco, which was incorporated under Newfoundland law in 1953. 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, renamed the Churchill River in 1965.

In 1958 Brinco established a federally incorporated subsidiary, the Hamilton Falls Power Company (HFPCo), renamed CFLCo in 1965. At Brinco's invitation, the Quebec-based Shawinigan Engineering Company took up a 20% interest in HFPCo with the right to maintain that ownership position if the corporation were to expand. Brinco retained the remaining 80%. Shawinigan's expertise in hydroelectric development and its prior working relationship with Brinco 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.

#### 1. *Political impediments*

Developing the Hamilton Falls would involve considerable challenges. Its magnitude and its distance from major markets—approximately 180 kilometres due east from the Quebec border and several hundred kilometres further from there to large population centres—presented substantial engineering and financial complexities. These technical problems were compounded by two political factors, both of which involved Quebec.

The first political problem had to do with a boundary dispute that had been settled decades prior to Newfoundland becoming a part of Canada in 1949. It concerned the inland boundary on the Labrador Peninsula,

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7. For more on the Smallwood era see Richard J. Gwyn, *Smallwood: the unlikely revolutionary* (Toronto: McClelland & Stewart, 1968), and Peter Neary, "Party Politics in Newfoundland, 1949-71: A Survey and Analysis" (1971) 6:4 *J. Can. Studies* 3-14; and (1972) 7:1, 3-21.

where Canada's and Newfoundland's claims overlapped. The government of Canada, at 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 Judicial Committee ruled in favour of Newfoundland.<sup>8</sup> That ended the legal dispute. Yet, the boundary remained a politically sensitive topic in Quebec.

The second political obstacle also involved territory. At times, HFPCo explored the option of selling to consumers beyond Quebec. To do so would entail transmission of electricity through Quebec. Under the Canadian constitution, embodied at the time in the *British North America Act 1867* and its subsequent amendments, provincial governments could not impede interprovincial trade. Still, Quebec governments were opposed to any attempt to transmit power over their territory. The political circumstances in Quebec since the late 1950s were such that the federal government was not anxious to confront Quebec over this matter.<sup>9</sup>

Occasionally, these territorial issues would flare up at the political level, with accusations and counter-accusations between Smallwood and the various Quebec premiers. It is fair to say that both Brinco/HFPCo and Hydro-Québec officials generally sought to avoid these sensitive matters but the political spats did at times impede progress in commercial negotiations.

## 2. *Early discussions*

Brinco first approached Quebec about a purchase agreement in the mid-1950s but talks were sporadic. 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 in order to expedite the development of major power projects. 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. If long-term export contracts were permitted then HFPCo might find buyers in the U.S. Alternatively, Hydro-Québec might be more inclined to make a deal with HFPCo in the knowledge that it might be able to sell any surplus power in the U.S. At the time, some U.S. utilities, notably Consolidated Edison, were expressing interest in importing power.

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8. *In the matter of the boundary between the Dominion of Canada and the Colony of Newfoundland in the Labrador Peninsula* (London: William Clowes, 1927).

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

The prospects for building on this impetus became severely complicated following the December 29, 1962 announcement by the Quebec government of its plan to nationalize all privately owned electricity utilities 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. According to Fullerton, it was on the instructions of the Quebec premier, Jean Lesage, that this takeover of 20% of HFPCo was done.<sup>10</sup>

Premier Smallwood was outraged at Quebec's intentions. In a meeting in mid-January 1963 with David Morgan-Grenville, an official of Brinco, Smallwood threatened 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."<sup>11</sup>

Despite the political animosity ignited by the Shawinigan matter, Brinco was encouraged by a meeting held on January 29, 1963 between Lesage and Brinco's chairman and chief executive officer H. Greville Smith. Lesage informed Greville Smith of his great interest in Hamilton.<sup>12</sup>

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.<sup>13</sup> Rio Algom itself was a Canadian subsidiary of the Rio Tinto Corporation, a significant shareholder in Brinco. Additionally, Rio Algom bought shares in Brinco and also purchased a minority ownership interest in HFPCo. Winters concerned himself with two key tasks: making progress on commercial negotiations and reducing the political friction.

As for a commercial agreement, in August, Brinco developed a twenty-two-clause draft proposal.<sup>14</sup> That draft, dated August 16, envisioned a thirty-year term beginning in June 1968, the time at which Hydro-Québec

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10. D. Fullerton, "Quebec, Labrador and Newfoundland," *Forces: Revue de documentation économique, sociale et culturelle* (No. 57-58, 1981-1982) at 46.

11. Morgan-Grenville's notes; Provincial Archives of Newfoundland and Labrador [PANL], Newfoundland and Labrador Hydro Corporation records, box 116, file: Premier of Quebec, 1963.

12. This prospect was reinforced in April 1963; in a letter dated April 7, 1964 to Premier Lesage, Robert Winters, Greville Smith's successor, recalled that "In April 1963 Hydro-Québec 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." Library and Archives of Canada [LAC], CFLCo Papers, MG28, III, vol. 37, file 2.04.003.

13. Smith, *supra* note 4 at 137.

14. LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 9.

would begin taking power. There was also a brief renewal provision, which stated:

Both HFPCo and Hydro-Québec 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 full-fledged negotiations between HFPCo and Hydro-Québec there was a renewal clause.

During the remainder of August, Brinco refined its proposal and presented it to Yvon De Guise, a senior official of Hydro-Québec, at a meeting on September 3. It was very similar to the August draft. 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-Québec on a take-or-pay basis at a yet-to-be-determined price. A significant portion of the remainder constituted what would become known 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 also made for possible recapture of a modest amount of the sales to Hydro-Québec 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-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.

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 retained the wording of the renewal clause except that it specified twenty years rather than twenty-five as previously.

Winters’ second key task on taking charge of HFPCo was to facilitate a reconciliation of the two premiers. One of the sensitive issues was the Quebec take-over of Shawinigan Engineering’s 20% interest. Lesage wanted Jean-Claude Lessard, Hydro-Québec’s president, to be appointed to HFPC’s board of directors. This, to Winters, introduced a conflict

of interest. Winters recorded that, in a meeting 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.<sup>15</sup>

On August 13, Winters met with Lesage and Lessard. According to his record of the meeting, he pointed out the possible conflict of interest if Hydro-Québec were to be on the Board of HFPCo while negotiating with it for the purchase of electricity. To resolve that conflict of interest, Winters suggested they consider selling back Quebec's 20% interest in HFPCo to Brinco and offered a substantial premium. Winters's record indicates that Lessard was impressed by the argument but that Lesage responded that his legal and financial experts all advised that Hydro-Québec retain its interest in HFPCo. Winters then outlined other options, such as allowing Newfoundland to be an equity participant. Lesage asked him to formalize his suggestions in writing, which he did.<sup>16</sup>

In a letter dated August 14, 1963 Winters repeated his concern about "a serious conflict of interest developing when Hydro-Québec is party to negotiations for both selling and buying the same power." He again offered to purchase Quebec's shares at up to \$20 each, practically double what the Quebec government had compelled Shawinigan to accept for them. His letter also outlined shareholding possibilities that would incorporate Newfoundland participation if Hydro-Québec were to retain an ownership position in HFPCo.

By the end of 1963, Winters was able to find a compromise. Smallwood agreed to take a 5% interest in HFPCo rather than achieve parity with Hydro-Québec. Lesage agreed to allow the Hydro-Québec position to be diluted to 15% and agreed that a Newfoundland royalty of 8% on Brinco's pre-tax net income would be extended to all such income earned by HFPCo, not just Brinco's share of it.<sup>17</sup> In return for the latter concession, Brinco transferred some additional shares in HFPCo to Hydro-Québec. The resulting ownership structure of HFPCo would be:<sup>18</sup>

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15. Memorandum accompanying letter from Robert Winters to A.W. Southam (5 July 1963), LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 7.

16. Notes of conversations on 13 August 1963 between Premier Jean Lesage, Mr. J. C. Lessard and Mr. Winters. 14 August 1963, Toronto, LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 7.

17. See letter from Winters to Lesage, 3 December 1963, LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 2.04.003.

18. This allocation was not fully realized until Rio Algom took up its option to buy shares allocated to it. According to Brinco's Annual Report for 1966 (at 8) Rio Algom did so in February 1967.

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

and, despite Winters's concerns over conflict of interest, Hydro-Québec got its seat on the HFPCo Board. Jean-Claude Lessard took the position on January 22, 1964. In June of the same year, following Newfoundland's acquisition of its 5% interest, the chairman of the Newfoundland and Labrador Power Commission, George Hobbs, also joined.

Thus, by the end of 1963 substantial progress had been made. The question of ownership positions in HFPCo had been resolved and commercial talks were well underway. HFPCo was making expenditure commitments for 1964 in anticipation of a power-purchase agreement.

### 3. *Difficult negotiations*

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-Québec 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 30<sup>th</sup> draft also provided for a thirty-five-year term rather than thirty as in the original proposal and the October 7<sup>th</sup> one, and it envisaged first power in 1969. It continued to recognize that Hydro-Québec might re-sell some of the power to Consolidated Edison. To facilitate financing, it also contained a provision under which Hydro-Québec'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-Québec's Lessard suggested a price of 2.0 mills. He also offered that Hydro-Québec 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.

Shortly thereafter, Hydro-Québec struck a committee to examine price and to discuss prospects with HFPCo. That committee had wanted to convert HFPCo into a public corporation. However, recognizing that the other shareholders did not want to sell their shares and Quebec's inability to expropriate HFPCo, its report outlined what an agreement acceptable to Hydro-Québec should entail. It suggested a price of 2.5 mills under a contract lasting thirty-five years from the first delivery of energy.<sup>19</sup> Among its other recommendations, the committee also wanted that Hydro-Québec's holdings in HFPCo be increased to 25% and that HFPCo be required to have an office in Quebec so it could be liable to Quebec income tax. Regarding renewal, the report suggested that Hydro-Québec be given a preference for purchasing all the energy not required by Newfoundland, at negotiated rates, when the contract expired.

On June 29, Winters met with Lesage. The former's record of the meeting indicates that the conditions put forward remained too onerous.<sup>20</sup> Winters pointed out that HFPCo's retained earnings over the life of the contract would show deficits if the price were 2.65 mills or less. Lesage suggested that the Quebec government might assist by undertaking to guarantee any cost over-run. Winters sought more undertakings, namely:

- 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.

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 it would be able to raise sufficient funds to complete the project, would turn out to be a key characteristic of a subsequent Letter of Intent. However, agreement on that Letter would take some time to reach. On July 8, in the Quebec Legislature, Lesage announced that it was impossible to reach an agreement at the time.

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19. The report of the five-member committee was in the form of a letter dated 8 June 1964 to Lesage, Lessard and the then Minister of Natural Resources, René Lévesque. It is included in vol. I, tab 21 of the record submitted on behalf of the second defendant-respondent, Hydro-Québec, formerly Quebec Hydro-Electric Commission in *Attorney General of Newfoundland v. Churchill Falls (Labrador) Corporation Limited, Quebec Hydro-Electric Commission, Royal Trust Company and General Trust of Canada* (1983), 49 Nfld. & P.E.I.R. 181, 145 A.P.R. 181, held at The Centre for Newfoundland Studies, QEII Library, Memorial University.

20. See "Note of Meeting between Messrs. Lesage and Winters in the Prime Minister's Office Quebec on June 29, 1964." LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 2.04.003.

Following this breakdown, HFPCo considered transmitting power via the so-called Anglo-Saxon route, one which Smallwood, frustrated with Quebec, favoured. That route involved transmission of electricity from the development site to the south coast of Labrador, connecting to the Northern Peninsula of the island by subsea cables and continuing from there with more subsea links to Nova Scotia. HFPCo concluded that this much lengthier route to market was uneconomic.<sup>21</sup> As for passing through Quebec, Lesage made it clear that he would never agree to it.<sup>22</sup>

In early 1965, Winters was considering his options. On January 5, he wrote Smallwood that selling power to Hydro-Québec “at 2.75 mills, the return to HFPCo and hence to the Brinco shareholders is not too exciting a prospect.” Brinco had calculated that 2.75 mills would yield a return of 6.8% on rate base, i.e., on invested capital, and that a price of 3.15 mills would be needed to obtain a return of 7.5%.<sup>23</sup>

One way of improving the commercial outcome was to seek tax relief. Thus Winters, in a letter to Smallwood dated February 3, 1965, raised the idea that the federal government eliminate its corporation tax on privately owned electricity generators. He also indicated that he would be exploring the possibility of taking the power through Quebec rather than selling it there.<sup>24</sup>

Regarding a return to formal negotiations on a sale agreement, Winters and Lesage met to review their positions on April 24, when they discussed ways to mitigate HFPCo’s price.<sup>25</sup> These included: elimination of federal corporate tax and Newfoundland provincial taxes, the use of direct-current transmission, and a longer repayment period for bonds.<sup>26</sup> Lesage and Winters also discussed rapprochement with Smallwood.<sup>27</sup>

A May 1, 1965 letter to Hydro-Québec from Winters re-ignited the negotiations. It contained two proposals, A and B. If Hydro-Québec did

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21. See “Review of pertinent considerations on alternatives for the development of Hamilton Falls Power,” 21 January 1965. LAC, CFLCo Papers, MG28, III, 73, vol. 46, file 12.

22. “Memorandum of a Meeting between Premier Lesage and Messrs Bourget and Monast at the Prime Minister’s Office, on Thursday, 27<sup>th</sup> of August, 1964.” LAC, CFLCo Papers, MG 28, III, 73, vol. 37, file 2.04.003.

23. LAC, CFLCo Papers, MG28, III, 73, vol. 37, file 9.

24. Archives and Manuscripts, QEII Library, Memorial University, Joseph R. Smallwood Papers, collection 285, file 14.06.015.

25. LAC, CFLCo Papers, MG28, III, 73, vol.37, file 2.04.003.

26. Letter from Winters to Smallwood (18 January 1965), Archives and Manuscripts, QEII Library, Joseph R. Smallwood Papers, vol. 285, file 14.06.015. Up to then the bonds had been assumed to be for twenty-five years.

27. 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 the Prime Minister a letter dated April 28 in this regard. LAC, Lester Pearson Papers, MG 26, N3, vol. 80, file 313.2.02.

not want to purchase the power, Proposal A entailed the construction of a transmission line across Quebec to markets elsewhere in Canada and in the United States. Alternatively, Proposal B offered a sale agreement to Hydro-Québec. Conditional on the previously discussed undertakings, it suggested a forty-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. Also, there would be a formula to adjust the price in relation to actual final cost. Before the end of the month, Hydro-Québec and HFPCo were working on a draft Letter of Intent.

During this time, and despite Smallwood's preference for Proposal A, Winters also had success in reconciling the two premiers. Indeed, on June 7, Premier Smallwood wrote the Prime Minister confirming that an understanding had been reached amongst Newfoundland, Quebec, HFPCo and Hydro-Québec regarding development of the Churchill Falls. He requested that the federal government eliminate the federal corporation tax on private producers and distributors of electricity. To that end, in July the federal government announced that it would increase its rebate to provincial governments of federal corporate income tax paid by utilities from 50% to 95%. This higher rebate would be embodied in new legislation, namely, the *Public Utilities Income Tax Transfer Act* (PUITTA).<sup>28</sup> Newfoundland could then, as agreed, give half of this enlarged rebate to HFPCo, which would in turn pass it on to Hydro-Québec through the price.

On June 8, 1965 Hydro-Québec sent a draft Letter of Intent 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 forty-four years from first power, rather than the thirty-five years of previous discussions and four years more than Winters's most recent concessionary offer of forty years. That was an enormous concession since it prolonged the low-price regime. 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-Québec to provide loan guarantees if the capital cost exceeded the estimate. There was also a renewal clause, which stated:

Hydro-Québec 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

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28. S.C. 1966-67, c. 43. David B. Perry, *Financing the Canadian Federation, 1867 to 1995: setting the stage for change* (Toronto: Canadian Tax Foundation, 1997) at 72.

then be willing to sign with a third party other than Newfoundland.<sup>29</sup>

The significant addition to the renewal clause was Hydro-Québec'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 forty-four years from the availability of first power was much longer than the thirty-five years contemplated in earlier negotiations. Renewal was thus pushed much further into the future.

#### 4. *Agreement*

Still, another year of negotiations passed before the Letter of Intent was finalized. Technical studies by Hydro-Québec and the resignation of Winters in December of 1965 were among the reasons 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 renamed the Churchill, and consequently HFPCo adopted its new name, CFLCo.

A Quebec provincial election was held in June of 1966, leading to a further delay. Lesage's Liberals were defeated by the Union Nationale, and the new premier, Daniel Johnson, wanted time to review the matter. By September a new draft Letter of Intent had been formulated. Robert Boyd, Hydro-Québec's general manager, strongly endorsed the agreement in a letter to Hydro-Québec's commissioners. He highlighted several points of advantage, notably the cost being lower than any other source available to Hydro-Québec, including nuclear energy. Boyd's letter went on to say

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.<sup>30</sup>

On October 3, Hydro-Québec approved the Letter and on October 6 it received government authorization. On October 13, Donald McParland and C. T. Manning for CFLCo and Jean-Claude Lessard and Jean-Paul Gignac for Hydro-Québec signed the agreement. On the Newfoundland side, Smallwood had been increasingly frustrated by the delays and was

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29. Record submitted on behalf of the second defendant-respondent, Hydro-Québec, formerly Quebec Hydro-Electric Commission in *Attorney General of Newfoundland v. Churchill Falls (Labrador) Corporation Limited, Quebec Hydro-Electric Commission, Royal Trust Company and General Trust of Canada* (1983), 49 Nfld. & P.E.I.R. 181, 145 A.P.R. 181, held at The Centre for Newfoundland Studies, QEII Library, Memorial University.

30. *Ibid.*

threatening to send a letter to the Prime Minister, Lester Pearson, asking that the project be declared in the national interest and for the federal government to build a transmission line through Quebec.<sup>31</sup> However, when informed of the deal, he was delighted, writing “praise be to God” in his diary.<sup>32</sup> Also in October, Premier Johnson announced that a commission would study and report on the boundary question, effectively decoupling it from the power contract.<sup>33</sup> With Smallwood’s decision not to send his letter and with Johnson’s sidelining of the boundary issue, the significance of these political matters faded.

The agreed Letter of Intent now put the contract’s term at either forty-four years from first power or forty years from completion of the last generating unit, whichever was longer. As for the renewal clause, its wording was consistent with all prior drafts and now read:

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. 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.<sup>34</sup>

The Letter of Intent represented a compromise between the approaches of the two negotiating parties and reflected the basic quid pro quo arising from the discussions between Winters and Lesage in April and May of 1965. On the one hand, Hydro-Québec would be obtaining a very large amount of power, approximately 32 million megawatt hours annually, under a very attractive price regime. The price would be approximately 2.6 mills during construction and, thereafter, fall in stages until it was slightly less than 2.3 mills for the last fifteen years of the term of the contract. These prices were tied to the capital cost so if the facility cost less than anticipated then the savings would be passed on to Hydro-Québec through a downward adjustment in price. Moreover, CFLCo had acceded to a much longer contract term during which the low-price arrangements would apply.

On the other hand, CFLCo received some important undertakings that were intended to assist it in raising sufficient funds to complete the project

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31. Smallwood obtained cabinet approval to appeal to the federal government under Order-in-Council 661-66, September 13, 1966.

32. Archives and Manuscripts, QEII Library, Memorial University, Smallwood Papers, col. 285, file 1.10.006.

33. The commission concluded that there was no judicial basis for challenging the boundary; see H. Dorion *Rapport de la Commission d’Étude sur l’Intégrité du Territoire du Québec*, vol. 3.2 (Québec, 1971) at 12.

34. LAC, CFLCo Papers, MG28, III, vol. 107, file 7.

and to ensure that it could remain solvent during the term of the contract. The Letter provided for adjustments in the price if the capital cost turned out to be higher than estimated or if the interest costs were higher than then contemplated. The exchange-rate risk—most of the financing would be borrowed in the U.S.—would be shared. Also, Hydro-Québec would either guarantee, or provide, a loan if there was a capital cost over-run and CFLCo could not otherwise obtain the necessary funds to complete the project. This arrangement as it evolved would become known as the completion guarantee.

In short, the *quid pro quo* was a long-term low-price regime by CFLCo in exchange for Hydro-Québec's undertakings to take or share various risks. Both parties recognized that it was in their mutual interest that the project be completed and at no time had there been any disagreement over the renewal provisions.

With the comprehensiveness of the Letter of Intent and the dissipation of the interprovincial political difficulties, it might have seemed that reaching a definitive power contract would be a straightforward task. Not so.

## II. *Contract negotiations*

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.

By March 1967, CFLCo envisaged a schedule that would lead to a power contract by October 31 of that year.<sup>35</sup> For CFLCo the key negotiator was Donald McParland. Typically during the negotiations, McParland was accompanied by Eric Lambert, vice-president (finance), C. T. Manning, vice-president (legal), and John Tennant, a Montreal lawyer. Hydro-Québec's key negotiators included Robert Boyd and Yvon de Guise, as well as other members of senior management and legal advisors. At a late stage, Jean-Paul Cardinal and Marcel Lajeunesse, representing the government of Quebec, joined the discussions.<sup>36</sup>

35. John Tennant's "Memorandum of CFLCo Meeting of March 10, 1967." PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170.

36. Smith, *supra* note 4 at 287, states that they entered the discussions at the request of Quebec premier Daniel Johnson. By January or February 1968 they were actively involved in negotiations.

1. *Brinco's financial challenges*

To meet Hydro-Québec's requirement for first power, which was now 1972, CFLCo had undertaken a substantial expenditure program for 1967. While no disagreements had developed, by the spring of 1967 CFLCo was anticipating that reaching an agreement on the 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.

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 Montreal to cover anticipated expenditures from April to June 1967. To cover July 1967 to June 1968, it needed an additional \$45 million. The plan was thus to raise \$37.5 million in a September share issue in CFLCo. 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 new CFLCo shares would be sold through a public offering. Assuming that the other three shareholders—Hydro-Québec, Rio Algom, and Newfoundland—held their relative positions, Brinco's ownership in CFLCo would fall to approximately 40%. It intended to maintain that position when a second issue of shares, planned as part of the overall financing package, was forthcoming in June.

CFLCo's planned public offering failed. The issue was abruptly cancelled in October. According to a letter issued to its shareholders on October 31, 1967, Brinco informed them that "Owing to market conditions,...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 arranged 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. As a result of these and related transactions, the direct ownership interests in CFLCo became:<sup>37</sup>

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

Remarkably, Hydro-Québec also owned a 2.04% interest in Brinco; thus giving it a further indirect interest in CFLCo.<sup>38</sup>

Not only did its ownership position in CFLCo decline but, contrary to plan, Brinco was now saddled with an additional \$21 million in bank debt. Brinco's financial position became such that in the following months Donald Gordon, its president and chief executive officer, approached one of its founding shareholders, Rio Tinto-Zinc, for rescue.<sup>39</sup> As of June 1967, Rio Tinto-Zinc's direct ownership of 4.16% of Brinco likely made it one of the largest single shareholders; and this was reinforced by a further 6.04% owned by Rio Algom.<sup>40</sup> Brinco was originally owned by a small number of investors but by 1965 was listed on the Montreal Stock Exchange and had a large number of shareholders. While negotiations between CFLCo and Hydro-Québec edged forward in 1968, there were parallel complex and confidential financial discussions undertaken by Brinco, Rio Tinto-Zinc and potential investors aimed at addressing Brinco's precarious finances.

## 2. *Negotiations to January 1968*

Despite its much weakened financial situation, by the end of October 1967 Brinco did have good reasons to be optimistic about CFLCo's prospects. Hydro-Québec would need all the power from Churchill Falls so a resale 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-Québec's desire for new power by 1972, there was less

37. Brinco *Annual Report* 1967, at 4 and 10, and "Churchill Falls (Labrador) Corporation Limited: Equity Financing and Advances" October 20, 1967, LAC, CFLCo Papers, MG28, III, 73, vol. 62, file 15.

38. "Interim Financing: The Problems and a Suggested Solution," June 3, 1967, at 9. LAC, CFLCo Papers, MG28, III, 73, vol. 62, file 7.

39. Joseph Schull, *The Great Scot: a biography of Donald Gordon*, (Montreal: McGill-Queen's University Press, 1979) at 260.

40. "Interim Financing," *supra* note 38.

time available for it to switch to alternative sources, and its willingness to participate in the share issue was a sign that it wanted Churchill Falls to proceed.

Also, progress had been made on the contract and no severe difficulties had arisen. By early July, a Power Contract Format had been exchanged between the two parties. Following a request from Hydro-Québec in August, it was agreed that one more generating unit would be installed, bringing the total to eleven. 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-Québec 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.<sup>41</sup>

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.<sup>42</sup> A first draft contract was exchanged, followed by an October 6<sup>th</sup> 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 first paragraph of that draft's renewal clause was:

Hydro-Québec 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-Québec 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.<sup>43</sup>

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41. "C.T. Manning's Record of meeting of Power Contract drafting committee of May 2, 1967" PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

42. "Minutes of a Meeting held in the Board Room on September 5, 1967," dated 7 September 1967. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D).

43. *Ibid.*

That paragraph was followed by one that elaborated on Hydro-Québec's right of first-refusal for sales in Quebec should the parties not succeed in negotiating a mutually acceptable renewal.

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."<sup>44</sup> More drafts followed, including ones dated October 27, November 3 and November 13. Despite CFLCo's November 30<sup>th</sup> target, negotiations continued. However, in an internal memorandum 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 three more drafts were prepared. 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."<sup>45</sup> An agenda prepared by CFLCo 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."

CFLCo's efforts produced a draft dated January 15, 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 substance of the renewal section was unchanged except that it now stated that if parties failed to reach a renewal agreement at least eight years prior to the expiry of the contract then Hydro-Québec's right to renewal would lapse.

Two other important articles of the January 15<sup>th</sup> draft deserve mention because of their relevance to subsequent developments. One was the article entitled "Completion Guarantee." It had its 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 can be traced back to the offer by Premier Lesage to Winters at their June 29, 1965 meeting, and it

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44. Eric Lambert's "Notes for Meeting to be held Tuesday, October 24, 1967" dated 23 October 1967. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

45. "CTM's record of meetings relating to the Power Contract 3 and 4 January 1968." PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D). Note that "CTM" refers to C. T. Manning.

was embodied in Clause 25 of the Letter of Intent.<sup>46</sup> 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 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. 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-Québec would advance loans to cover the gap.

### 3. *The events of February 1968*

Following the January 15 draft, negotiations continued into February. On February 13, the CFLCo Board met. The minutes of that meeting, which had to be obtained by a freedom-of-information request to CFLCo, provide important information on the situation. According to those minutes, McParland reported:

A draft contract had been delivered to Hydro-Québec and counsel for the Government at the end of December, followed on January 15<sup>th</sup> 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.<sup>47</sup>

Hydro-Québec’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 prediction of an imminent contract.

Yet, quite astonishingly, the minutes of the meeting indicate that Mr. Lessard did inquire whether the January 15<sup>th</sup> draft represented CFLCo’s “maximum conditions.” According to the minutes, the board chair, Donald Gordon, responded that the January 15<sup>th</sup> draft represented the conditions that CFLCo’s financial advisors felt investors would insist upon.

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46. This Completion Guarantee article first appeared in the December 21, 1966 draft. Prior to that, it had been intended that such a guarantee not be embodied in the contract but dealt with separately; see Annotation to the October 6, 1967 draft contract.

47. Minutes of the 56<sup>th</sup> meeting of the board of directors of Churchill Falls (Labrador) Corporation Limited, 13 February 1968. CFLCo file #ATIP-2005-0004 at 4.

Later in the same meeting, the Board was informed by Gordon that its cash position would be \$14 million at the end of February, that accounts payable were running at \$5 million monthly, that \$1.2 million would be left by the end of May, and that the cost of cancellation was estimated at \$5 million. The implication was that CFLCo had only enough funds to last another two to three months. However, this impending shortage of funds was not presented in a way that raised fears. Gordon pointed out that he anticipated that bridge financing of approximately \$10 million would be readily arranged with the bank if satisfactory progress on the power contract and major financing could be demonstrated. He went on to suggest that with the arrangements being made for the financing plan and in anticipation of more progress, a planned meeting with the bank at the end of March would lead to the necessary access to funds. Apparently, the \$10 million was anticipated as sufficient to maintain the project until funds from major financing were in place.

In short, the tone of the meeting was positive. From CFLCo's perspective a contract would be approved in the near future, and, while funds were running out rapidly, the bank would provide bridge funding to last until major financing was in place. Progress on both the contract and the financing plan was dependent on Hydro-Québec.

There is no indication from the minutes that this impending shortage of funds, nor the fact that Lessard was being made aware of it, nor his question regarding CFLCo's terms, raised any concerns at the board meeting. Perhaps any misgivings about a Hydro-Québec official being on the CFLCo board and having access to such information had dissipated. After all, the Letter of Intent had been signed, there had been no serious disagreement in the negotiations to date, and there was a positive and cooperative relationship between McParland and Hydro-Québec officials.<sup>48</sup> Also, as a substantial shareholder with representation on the CFLCo board, Hydro-Québec presumably had a responsibility for CFLCo's interests.

As it turned out, however, this February meeting was both an extraordinary and a pivotal event. It was extraordinary because it explicitly demonstrated the extent to which Hydro-Québec had access to CFLCo, both in terms of governance and information. These circumstances are reminiscent of the problem raised repeatedly by Robert Winters years earlier and led him to suggest to Lessard to seek legal advice as to whether there would be a substantial conflict of interest. The Hydro-Québec president was participating as a CFLCo board member in a board meeting

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48. Smith, *supra* note 4 at 231-232 points out that when McParland took over negotiations, he quickly established a strong rapport with Hydro-Québec officials.

dealing with the contract and even inquired as to CFLCo's flexibility on its conditions. He was also learning first-hand of CFLCo's approaching cash crunch. The meeting was pivotal because practically immediately afterward, Hydro-Québec sought substantial new concessions and was able to secure them over the following eight to ten weeks, after which time the final parameters of the contract and related arrangements were effectively settled.

At a meeting on February 14, just one day after the board meeting, Hydro-Québec informed CFLCo that it was preparing its own draft of the contract. That Hydro-Québec draft, dated February 18, 1968, was submitted to CFLCo's McParland under a covering letter from Robert Boyd stating that this draft was to serve as a basis for further discussion. Ominously, it also indicated that more changes to the draft would be forthcoming.<sup>49</sup>

Hydro-Québec's February 18 draft itself sought a significant new concession. It provided that new shares in CFLCo be attached to any loans advanced to CFLCo by Hydro-Québec under the Completion Guarantee article (Article V of that draft). If the article were ever triggered, Hydro-Québec, under this draft's 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 long-term and low-price regime in exchange for assurances of such advances if they were needed, which would be repaid with interest. Now, Hydro-Québec was proposing to change the arrangement so that it could obtain a larger ownership position as well.

Still, 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. It read:

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. Should Hydro-Québec 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

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49. Letter from Boyd to McParland (23 February 1968), PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D).

parties fail to agree upon renewal within the aforesaid time limit, Hydro-Québec's right to renew shall thereupon lapse.<sup>50</sup>

This would soon change.

#### 4. *A price formula for renewal*

The first evidence that any change in the renewal clause was being contemplated is in the form of two pages of handwritten notes. The existence of these notes, which were found by the authors uncatalogued in CFLCo's archived records, was, apparently, not previously known. They shed new light on CFLCo's reaction to Hydro-Québec's attempts to alter radically the terms for renewal. They 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 the contract could be extended for an additional ten to twenty-five years at a fixed mill rate. They indicate that this would avoid criticism from proponents of nuclear power. Next, the notes turn to the Water Power Lease, i.e., the lease from Newfoundland under which CFLCo had access to the Churchill Falls watershed. Under a 1967 statutory amendment to the lease, the provincial government, having successfully lobbied the federal government to increase the rebate of federal corporate income taxes on private utilities, would turn over the increased rebate to CFLCo.<sup>51</sup> The purpose of this was to support the low-price regime for Hydro-Québec. The lease, as amended in 1967, provided for this rebate for the term of the power contract, which the lease anticipated as approximately 40 years. It explicitly excluded the rebate continuing for any renewal period. Hence, Manning's concern. Also, under the lease, it was only for the term of the contract that CFLCo was sheltered from a number of provincial and municipal taxes as well as from any new such taxes, fees royalties etc., and from increases in rates of applicable taxes.

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50. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D).

51. More precisely, the 1967 *Churchill Falls (Labrador) Corporation Limited (Lease) (Amendment) Act, 1966-67*, S.N. 1966-67, no. 84, stipulated that 47.9% of all funds collected through federal taxes on CFLCo's income and rebated to the provincial government would then be turned over to CFLCo for the term of the contract.

On the top of the second page of his notes, Manning concludes that granting Hydro-Québec 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 the replacement cost of plant and equipment, and to avoid prejudicing an agreed return on equity.

In the last part of his 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 forty-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 included in a formula-based price for the extension period. Finally, on the last line of his notes, Manning simply writes “Defeats purpose.”

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 price formula that would reflect:

- the cost of major capital replacements and repairs;
- the loss of the PUITTA rebate to CFLCo;
- the escalation in operating costs, including the loss of shielding from provincial taxation;
- the Lease’s rental and horsepower royalty; and
- an agreed return on equity.

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

### 5. *The “do-or-die condition”*

On Wednesday, February 28, the negotiators met to discuss Hydro-Québec’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.<sup>52</sup> CFLCo pointed out that elements of the Completion Guarantee Article, notably the provisions by which Hydro-Québec 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-Québec 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-Québec’s Robert Boyd and his group, together with Marcel Lajeunesse representing the Quebec government, 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-Québec. On this matter, Manning’s record is:

Mr. Boyd pointed out that an extension of the term to Hydro-Québec 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.<sup>53</sup>

Despite the diplomatic tone of the last sentence, Manning’s hand-written notes taken at the same meeting, and reproduced in Appendix II, reveal something else. Those notes, like those reproduced in Appendix I, were located uncatalogued in CFLCo’s archived records and their contents were not previously known.

52. “CTM’s record of meeting with Hydro-Québec 28.2.68 at their offices,” PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

53. *Ibid.*

Interestingly, these notes start with the “query” on renewing for a lesser amount of power at a reduced rate, which foreshadow a CFLCo attempt to obtain a less onerous renewal clause. 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 Manning’s notes is his characterization of Hydro-Québec’s demand as

“A Do or Die Condition.”

This request to replace the renewal clause came at a time when CFLCo had about twelve 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-Québec itself had prepared, the substance of the renewal provisions had remained the same. Following the expiry of the contract’s term—the length of which had been extended to a minimum of forty-four years as part of the 1965 breakthrough in negotiations—there was to be mutual agreement on price and quantity for the renewal and Hydro-Québec would have a right of first refusal for sales for consumption in Quebec. Throughout the years of negotiations there was no indication of any desire of either party to deviate substantially from those agreed points.

Boyd’s statement intimated a linkage between this change in the renewal and the Completion Guarantee. However, a completion guarantee had been part of the long-agreed quid pro quo. The parties had agreed that the contract would be extended from thirty-five years to forty-four years from first power under the low-price regime in exchange for Hydro-Québec’s various undertakings. Hydro-Québec 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, it was seeking an additional and extraordinary concession for which there would be no reciprocation. There were no allowances for the items listed 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-Québec's schedule for first power. Those efforts had practically exhausted CFLCo's access to funds by the time this demand was put forth as a "do-or-die condition."

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, forwarding revised drafts of sections dealing with the Completion Guarantee and related items. On March 6, there was another meeting between CFLCo and Hydro-Québec and the Quebec government representatives. According to Manning's record of that meeting, a number of riders, which had been submitted to Hydro-Québec the previous day, were agreed.<sup>54</sup> They also reviewed a list of provisions that still needed to be settled, including renewal. CFLCo representatives stated that it was under advisement but progress was being made and that CFLCo's response would be coming as soon as possible. Later in the meeting, Jean-Paul Cardinal, representing the Quebec government, suggested that the principal points 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-Québec new position on renewal was contained in an internal memorandum, dated March 7, 1968, which listed fifteen items that "appear to be required to complete the contract." The counteroffer on renewal, known as rider 34, was attached to that memorandum. The key elements of rider 34 read:

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-Québec shall pay for all energy made available to it by CFLCo, whether or not taken;

(b) the price payable by Hydro-Québec shall be payable in lawful money of Canada and the rate per kilowatthour applicable shall be the equivalent in Canadian dollars of 2.0 mills in U.S. funds[.]<sup>55</sup>

54. See "CTM's record of meeting with Hydro-Québec 6.3.68," at 2. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

55. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D).

This compromise proposal offered a fixed price of two mills in U.S. currency, which was approximately equal to the 2.2 mills in Canadian funds at the time. That was a very low price, even in 1968. 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-Québec would buy, up to a limit, all the electricity *made available by CFLCo*. That provision contained no floor on the amount that CFLCo could choose to make available to Hydro-Québec, only an upper limit, namely the Annual Energy Base, which the draft contract put at 31.5 million megawatt hours.<sup>56</sup> 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-Québec would have a fixed price of U.S. 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-Québec at that price. This attempt to determine the amount of power to be sold to Hydro-Québec at the reduced price was consistent with the “query” in Manning’s handwritten notes of March 1 which refers to the possibility of renewing for a lesser amount of power. (see Appendix II)

On March 11, the parties met again. Most of the meeting dealt with matters related to financing. CFLCo pressed Hydro-Québec to lower the \$700 million threshold, as provided for in the draft contract’s Article V, that CFLCo had to raise to qualify for the completion guarantee. CFLCo wanted it lowered to \$600 million, arguing for a time-phased approach which would allow CFLCo in the initial instance to raise a smaller amount of funds through bond sales. Then, if need be, it could go to the financial markets later to raise any additional funds in a second bond offering. According to the CFLCo side, this would put Hydro-Québec in a position where it would not have to put up any cash except if the second offering of bonds could not be successfully marketed and, even if that happened, it would not be until 1971 or 1972. CFLCo felt that such a time-phased offering would be easier to sell and would likely have more reasonable terms. Hydro-Québec’s Boyd responded that any reduction in the \$700 million threshold was unacceptable. At that point, 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.”<sup>57</sup>

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56. The contract allowed for modest adjustment of this figure at eight and later four-year intervals.

57. See “CTM’s record of meeting with Hydro-Québec 11.3.68 – 2:30 p.m.” PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

The meeting then turned to the concession that Hydro-Québec was seeking on renewal. CFLCo's rider was tabled. Manning summarized the ensuing discussion as follows:

Mr. McParland then dealt with the contract renewal and tabled a proposed revision to clause 3.2 which became numbered as rider 34. 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.<sup>58</sup>

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, including a commitment by Hydro-Québec to "indicate their agreement on riders 29 to 34 inclusive as soon as possible," rider 34 being CFLCo's proposed compromise on renewal.

On March 14, the parties representing Hydro-Québec, CFLCo, and the Quebec government met again. At the beginning of the meeting, CFLCo wanted to deal with the outstanding riders, namely riders 29 to 34. However, Lajeunesse indicated that his side had not had an opportunity to deal fully with them, and suggested that the meeting deal with various aspects of Article V – Completion Guarantee, and Article XII – Debt Service Requirement and Expenses Charges. Then the meeting turned to a number of Hydro-Québec's proposed riders to the February 18<sup>th</sup> draft. None appeared to be particularly contentious. Interestingly, part way through the meeting, Cardinal reiterated that he hoped that a contract would be before the Quebec cabinet by Monday, March 18, just four days away.<sup>59</sup>

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,

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58. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

59. See "CTM's record of meeting with Hydro-Québec 14.3.68 – 2:30 p.m.," *ibid.*

CFLCo indicated that they had sent the Hydro-Québec draft to their financial advisors and New York counsel. Also, CFLCo indicated that meetings with them would be arranged early the next week, i.e., the week of March 18, and invited Hydro-Québec to have their counsel participate in those meetings. The implication was that an agreement would not be possible by March 18, as Cardinal had hoped. Still, it appears that the parties were moving rapidly towards one, and there was still no sign that CFLCo's rider on renewal was not acceptable.

In the next few weeks, with CFLCo's funds dwindling, events moved quickly both in terms of the contract and the financial plan. Hydro-Québec also became more extensively involved in the latter.

#### 6. *The financial arrangements*

The fundamentals of the financing plan were largely in place by April. Realization of that plan depended on a power contract agreement and on meeting conditions put forth by Hydro-Québec. In a letter dated April 23, 1968 to CFLCo, Robert Boyd laid out the financial conditions required by Hydro-Québec. These conditions were external to the power contract but Hydro-Québec's recommendation to the Quebec government to authorize the contract was conditional on them. The main elements may be summarized as follows.

- **New Equity:** Hydro-Québec wanted to increase its ownership position in CFLCo.<sup>60</sup> It was agreed that \$25 million in new CFLCo shares would be issued in order to fund work later in the year. Existing shareholders would subscribe for them in batches over the summer months. Hydro-Québec would take \$15 million of these shares so it could bring its overall ownership in CFLCo up to 25.7%.
- **General Mortgage Bonds:** As part of the financing plan, CFLCo would offer \$100 million in general mortgage bonds, with ten bonus shares in CFLCo attached to each \$1000, solely to its four shareholders in accordance with their respective ownership positions. The other three shareholders would have thirty days to subscribe, after which Hydro-Québec would take any units that had been declined as well as take its respective share. (Later in 1968, Hydro-Québec changed the conditions under which CFLCo would offer these bonds so as to give CFLCo the option to require Hydro-Québec to take them exclusively.)

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60. See Minutes of joint meeting of the executive committees of the boards of directors of Brinco and CFLCo, April 10, 1968; obtained under CFLCo ATIP request 2005-0004.

- CFLCo to raise \$515 million: As a condition on the General Mortgage Bond arrangements, CFLCo had to agree to first obtain commitments, by a specified deadline, of at least \$515 million from investors, of which at least \$415 million would have to be for First Mortgage Bonds.<sup>61</sup> (This requirement was later included as a condition in Voting Trust Agreement No.1.)
- By-law 13: Hydro-Québec 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 CFLCo shares for certain decisions to be made. For instance, without 75% approval, 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-Québec to hold 25.7% by year's end, this would give it a veto over such matters.
- Voting Trust Agreement: An agreement was to be drawn up between Brinco and Hydro-Québec 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-Québec 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 then the trust company would vote those shares in accordance with Hydro-Québec's wishes. This would allow Hydro-Québec 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-Québec, giving it majority ownership, if CFLCo failed to meet certain financial conditions. (Later in 1968 this evolved into two agreements - Voting Trust Agreement No.1 and Voting Trust Agreement No. 2).

The implications of agreeing to these terms were far-reaching for CFLCo. It would have to act to satisfy them before the end of 1968. If it succeeded then Hydro-Québec's ownership position would increase to a minimum of 25.7% and Hydro-Québec would obtain a significant veto power under by-law 13. If it failed to meet these financial conditions in time then, via the Voting Trust agreements, management control and majority ownership could pass from Brinco to Hydro-Québec. For CFLCo and Brinco, there could be no turning back.

### 7. *De facto end of negotiations*

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.

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61. This requirement did not obviate the requirement that CFLCo raise at least \$700 million in financing as the threshold amount needed to qualify for the completion guarantee.

On April 10, 1968, when CFLCo was close to exhausting its available funds, the executive committees of the CFLCo and Brinco boards held a joint meeting. CFLCo's executive committee consisted of McParland as well as six others who were also members of Brinco's executive committee. The latter committee also included M.F. Nicholson, Brinco's general manager, and Maurice Bourget, a Quebec Liberal Senator.

At that time, they considered the points on which Hydro-Québec was insisting. According to the minutes of the meeting, CFLCo's McParland presented Hydro-Québec's demand on renewal as follows:

Hydro-Québec 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 kilowatt hour. 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 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.<sup>62</sup>

This synopsis is revealing in a number of ways. First, McParland pointed out that costs and therefore the mill rate would be higher for Hydro-Québec than anticipated in 1966, but does not acknowledge that this was generally true for costs of its alternate sites. Secondly, he failed to mention rider 34 or the related problems that Manning had identified, e.g., escalating operating costs, loss of tax concessions and the need for capital replacements, except to the extent he stated that any attempt to include escalators or the loss of tax concessions would defeat the purpose. On this point, he did not even address the question of whether two mills would even be sufficient for CFLCo to remain solvent during the renewal period. Thirdly, when he raised the spectre of nuclear power costs, his assessment was inconsistent with studies completed for CFLCo just two

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62. Minutes of a joint meeting of the executive committees of the boards of directors of Brinco and CFLCo, 10 April 1968, CFLCo file #ATIP 2005-0004 at 5.

months earlier. One report had reviewed the nuclear alternatives and had forecast that Canadian heavy water reactors would have generating costs of about four mills by the 1970s.<sup>63</sup> Another report observed that the life of a nuclear power plant, which had substantial capital costs, was thirty years, much less than a hydropower plant. That same report also noted that plants under construction in Ontario were expected to have generating costs of approximately 3.9 mills while one under construction at Gently in Quebec would have a generating cost of 4.75 mills.<sup>64</sup> Neither report ventured to make projections beyond the 1980s, let alone suggested that the *nominal* cost of nuclear power would be two mills or less after the year 2016. Indeed, had Hydro-Québec believed that nuclear power was going to be that cheap then it would have been in its interest to retain the original renewal clause. That way, at renewal time, it could seek an even lower price! Finally, McParland's presentation did not mention what he and all present knew, namely, that without an agreement within weeks CFLCo would be unable to pay its bills.

It appears that, having failed to convince Hydro-Québec to accept rider 34, McParland turned to the Brinco/CFLCo Executive Committees to give in, which they did. The joint meeting authorized conclusion of the negotiations, directing McParland to agree to Hydro-Québec's demands but with efforts to negotiate modifications in CFLCo's interests where possible.

The next complete draft contract was dated April 19, the first one since the February 18<sup>th</sup> 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, any advances made to it by Hydro-Québec but it would have to issue and turn over ten new shares for each \$1,000 advanced. This draft also extended the shares-for-advances principle to Article XII.<sup>65</sup> As for renewal, the key 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 kilowatt hours per year equal

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63. Churchill Falls (Labrador) Corporation Limited and Acres Canadian Bechtel of Churchill Falls, "Review of Current Nuclear Power Economics," Final Mock-up, February 12, 1968, p.44. LAC, CFLCo Papers, MG28, III, 73, vol. 105, file 11.

64. Churchill Falls (Labrador) Corporation "Draft Outline of Government Brief," p. VIII-7, draft of February 8, 1968, prepared by Wood Gundy. LAC, CFLCo Papers, MG28, III, 73, vol. 61, file 700.013.

65. If CFLCo were to ever call on Hydro-Québec under Article XII, the latter would receive either five shares per \$1000 advanced or ten shares per \$1000 in the event that the plant was destroyed.

to that which shall constitute, at the date of expiry hereof, the Annual Energy Base, shall be made available by CFLCo to Hydro-Québec and the latter shall pay for it, whether taken or not, at a price of 2.0 mills per kilowatt hour 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.<sup>66</sup>

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 two mills starting approximately fifty years in the future and continuing for twenty-five years thereafter. There was no consideration of any of the 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-Québec sent drafts of the financial arrangements, the Voting Trust Agreement, and By-law 13 to CFLCo.<sup>67</sup> His letter stated that, conditional on CFLCo's acceptance of those documents, Hydro-Québec was prepared to recommend the draft contract to the Quebec government. Two more drafts followed in April, dated April 25 and April 29. They contained small changes and clarifications with no more substantial concessions. Thus, before the end of April 1968, negotiations had effectively ended. CFLCo had made several concessions and it had completely capitulated to Hydro-Québec's demand regarding renewal.

On May 14, the executive committee of CFLCo and of Brinco held another joint meeting. Those present voted to authorize CFLCo to enter an agreement substantially in the form of the April 29<sup>th</sup> draft and to agree to the related financial conditions.<sup>68</sup>

On June 13, 1968 the Board of Directors of CFLCo met. It was their first meeting since February 14 when McParland had been optimistic about a deal being at hand. This meeting occurred when CFLCo effectively had no money. Around this time, CFLCo was sending staff with signing authority out of the office in order to have an excuse not to pay bills.<sup>69</sup>

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66. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163(D).

67. PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.163.1.

68. Minutes of a joint meeting of the executive committees of the boards of directors of Brinco and CFLCo, 14 May 1968, CFLCo file #ATIP 2005-0004 at 10 and 11.

69. Smith, *supra* note 4 at 289.

The board consisted of fourteen members, including the seven who were on the executive committee. Information was provided to the board members in summary form in a confidential memorandum that was distributed at the meeting and had to be returned at the end of the meeting. Both the minutes and the memorandum had to be obtained by a freedom-of-information request to CFLCo. 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.<sup>70</sup>

The eight-page memorandum devoted six lines to renewal, informing readers that it was to be in the form of a firm commitment at a flat rate of two mills in Canadian dollars. It also presented brief summaries of other important items, such as the voting trust arrangements.

Board members in attendance, including Hydro-Québec's Jean-Claude Lessard and the chairman of the Newfoundland and Labrador Power Commission George Hobbs, approved all the actions taken by the executive committee as summarized in the memorandum. The Board then specifically ratified and confirmed the executive committee's decision taken at its May 14<sup>th</sup> meeting to enter into a power contract substantially in the form of the draft of April 29.

In sum, the agreement on the draft contract was presented to the board of directors as a *fait accompli*. They received only a memorandum summarizing the decisions already taken and were asked to endorse them. The draft contract itself was not circulated and directors were not permitted to keep the memorandum. At the time, CFLCo had effectively exhausted all its available financial resources and no further funds could be obtained without an announcement of agreement.

### III. *Implications of the renewal clause*

In 2007 a price of two mills a kilowatt hour, which is equivalent to \$2 a megawatt hour, is an unbelievably low price. A contract that sets that price for twenty-five years starting in late 2016 is barely conceivable. The

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70. Minutes of the 58<sup>th</sup> meeting of the board of directors of CFLCo, 13 June 1968, CFLCo file #ATIP-2005-004 at 2.

resulting gain, or economic rent, that will accrue to Hydro-Québec is the difference between what the electricity will be worth to Hydro-Québec and what it will pay to CFLCo for it. A rough back-of-the-envelope calculation implies that the gain could have a net present value, i.e., be equivalent to a lump-sum payment in 2007, in the range of \$5 billion to \$30 billion.<sup>71</sup> This range is based on heuristic assumptions and, at best, should be treated as impressionistic.

What is more relevant to the issues at hand, are parties' assessments of the implications of the renewal clause at the time, 1968. That is the purpose of this section, starting with Quebec.

### 1. *Quebec*

In the first week of June 1968 Hydro-Québec 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 superseded the April 29 draft and was basically a cleaned-up version of it.

In a letter dated June 6, 1968, Hydro-Québec 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-Québec 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 manufacturers and contractors; and
- Hydro-Québec would own a minimum of 25.7% of CFLCo.

Regarding the renewal clause, 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.

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71. Both figures are based on sales of 29 million megawatt hours annually. The lower figure is based on the assumption that a megawatt is worth \$40 to Hydro-Québec in 2007, with that amount growing at a rate of one percent more than the general rate of inflation, and the resulting annual gains are subject to a real discount rate of ten percent. The higher figure starts with \$55 a megawatt hours, assumes a 3.5 percent increase above the inflation rate and uses a 5 percent discount rate. The figures given in the text are the rounded totals following from this procedure.

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.<sup>72</sup>

Lessard's letter concluded that the agreement was to "Hydro-Québec's greatest advantage." Several supporting documents were enclosed with Lessard's letter, including a Hydro-Québec report entitled "Hydro-Québec Construction Program," dated April 19, 1968. This report compared three alternatives for adding to the utility's 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. Thus, Churchill Falls was also superior to the set of remaining components of the Churchill Falls program.

In addition, the Hydro-Québec report identified the post-2015 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

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72. Record submitted on behalf of the second defendant-respondent, Hydro-Québec, formerly Quebec Hydro-Electric Commission, in the Supreme Court of Newfoundland Court of Appeal between: Her Majesty's Attorney General of Newfoundland, Plaintiff-Appellant and Churchill Falls (Labrador) Corporation Limited, first Defendant-Respondent and Quebec-Hydro Electric commission, second Defendant-Respondent and the Royal Trust Company, third Defendant-Respondent and General Trust of Canada, fourth Defendant-Respondent) (Evidence submitted in *Attorney General of Newfoundland v. Churchill Falls (Labrador) Corporation Limited, Quebec Hydro-Electric Commission, Royal Trust Company and General Trust of Canada* (1983), 49 Nfld. & P.E.I.R. 181, 145 A.P.R. 181, held at The Centre for Newfoundland Studies, QEII Library, Memorial University.

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.<sup>73</sup>

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

Another document, also enclosed with Lessard's letter, compared the draft contract agreement with the 1966 Letter of Intent. It echoed the conclusions of Hydro-Québec'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 and made interest rates higher. It also stated that potential first-mortgage bondholders required that Hydro-Québec'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.<sup>74</sup>

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.<sup>75</sup>

In short, in 1968, based on its own assessment, Hydro-Québec would have expected, without any anticipation of the oil-price shocks and high inflation of the 1970s, that the gains to it resulting from the new renewal clause would be extremely advantageous for the twenty-five years in question.

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73. *Ibid.*

74. *Ibid.*

75. *Ibid.*

## 2. CFLCo

The implications of the new renewal clause for CFLCo, assessed from a 1968 perspective, would have been unfavourable. Hydro-Québec could be expected to 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 for use within the province. At a price of two mills, Hydro-Québec would be paying CFLCo approximately \$58 to \$60 million annually during renewal. 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 by 3% annually.<sup>76</sup> 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-Québec would pay to CFLCo. The table also illustrates the sensitivity of such projections to small increases in the escalation rate. A rate of 4% or more would imply that these costs could actually exceed the payments made by Hydro-Québec.

Escalation Rate	Average annual Plant and Corporate Expenses
<u>from 1977</u>	<u>during the Renewal Period: 2017-2041</u>
3.0%	\$37.0 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 fifty to seventy-five years—would likely have reduced the comfort level associated with the use of any escalation rate, especially in circumstances where revenue would be largely fixed. Manning's notes of February 1968 well anticipated this uncertainty. (see Appendix I) 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.

76. CFLCo ledger sheets, dated July 22, 1968 have projections of plant and corporate expenses based on an escalation rate of 3%. LAC, CFLCo papers, MG28, III, 73, vol. 107, file 4.

Even if operating costs did not fully exceed revenues, 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 forty and fifty 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 forty years following completion, replacements of major components were not anticipated but that an engineering study would be needed to consider replacements after fifty or sixty years. To illustrate, allowing for 2.5% escalation in nominal capital costs starting from 1976, a capital item would cost three 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-Québec then in addition to having to repay Hydro-Québec, it would have to provide new shares to Hydro-Québec. 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.

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 equity shareholders of CFLCo would have had little prospect of earning any positive return during the renewal period. In acquiescing to Hydro-Québec's do-or-die condition, CFLCo's management would have understood that during the twenty-five-year-renewal CFLCo shareholders would likely suffer losses or, at best, barely

cover costs. In 1968, two mills was likely the lowest conceivable price at which CFLCo could be expected to cover costs during the renewal period, if that. In other words, all the economic rent from the project, i.e., the difference between its market value and the cost of producing it, would accrue to Hydro-Québec.

Without a future amendment to the two-mill twenty-five-year renewal clause, CFLCo would have no opportunity whatsoever to share in any increase in the market value of the electricity taken by Hydro-Québec. 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-Québec's ultimatum of March 1, 1968, one perceived by senior CFLCo management as a "do or die condition." 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.

### 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 would share in the economic rent was through an 8% rental on CFLCo's pre-tax profit. With little or no prospect that CFLCo would make any 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. During renewal, CFLCo would no longer be entitled to a share of the provincial government's PUITTA rebate but, without CFLCo earning any profit, that also would be of little or no value to the province. The only revenue of which Newfoundland could be relatively certain was the horsepower royalty revenue, which had been established in the statutory water power lease with CFLCo. It was a fixed amount of approximately \$2.6 million per year and 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. Even that would be at risk if CFLCo's revenues could not cover other costs. That compares dramatically with Hydro-Québec's own anticipation of earning between \$29 and \$30 million per year for each mill difference between the cost of alternative sources and two mills.

As with the Letter of Intent, the Newfoundland government was not party to the contract negotiations. It was via a telephone call from CFLCo's board chairman, Donald Gordon, that Premier Smallwood first learned that the renewal clause had been replaced. Gordon, who was also Brinco's president and chief executive officer, called on Friday, July 12, two days after the Quebec government authorized Hydro-Québec to proceed with finalization of the deal. July 12 was also the same day that Hydro-Québec issued its press release announcing the decision to proceed with the project and including reference to the new renewal clause. Gordon kept a record of his telephone conversation with Smallwood. Apparently, this record, like Manning's notes in the appendices, had not been uncovered until this research was undertaken. Its text, which uses Smallwood's initials, J.S., is as follows:

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.

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.<sup>77</sup>

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77. See "Notes of Telephone Conversation with J.R. Smallwood, Premier of Newfoundland on 12 July 1968." PANL, Newfoundland and Labrador Hydro Corporation records, box 115, file 500.170(D).

This record is revealing. Only after Smallwood expressed his congratulations on the deal did Gordon mention renewal, and it was the only issue he raised.

When told of the renewal, Smallwood's remark about the renewal price of two 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-Québec the right to renew was highly misleading. The Letter's renewal clause provided for negotiations for mutually satisfactory terms on price, quantity, and other conditions. That 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.

Also, Gordon's remark to Smallwood that by the end of the forty-year contract costs would be minimal and the project debt free was either dishonest or misinformed. Manning's notes of February 1968 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.<sup>78</sup>

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 province's PUITTA rebate to CFLCo so it could give a lower price to Hydro-Québec.<sup>79</sup> Earlier, Smallwood himself had successfully lobbied the federal government to increase the rebate to enable this transfer to take place. As far back as the 1950s it had been appeals by Smallwood to British Prime Minister Winston Churchill, the Rothschild merchant

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78. Ledger sheets, dated July 22, 1968, from CFLCo archives. LAC, MG28, III, vol. 107, file 4.

79. *The Churchill Falls (Labrador) Corporation Limited (Lease) (Amendment) Act, 1966-67*, S.N. 1966-67, no. 84, exempted CFLCo from the provincial retail sales tax and gasoline tax, and from any increase in existing provincial taxes and from any new taxes during the term of the contract.

bankers and other leading British industrialists and financiers that led to the formation of Brinco.

While Smallwood had an inkling of the implications of renewal, he did not pursue the matter. Apparently, neither did any other provincial politician or policy-maker at the time even though newspapers reported that Quebec had gained concessions and mentioned the renewal provision and the price of two mills.<sup>80</sup> Smallwood himself had relatively little to say about the deal over the next few months. Questions could not be asked about it in the provincial legislature as its session was over. There was a call from the editorial page of *The Evening Telegram*, one of the two major newspapers in the province at the time, for more information on the deal and for a re-opening of the legislature to debate the matter.<sup>81</sup> That did not happen.

Whether Smallwood thought of intervening after the telephone call from Gordon is not known. If he had, there was little that could be done because on Monday, July 15, 1968, just a weekend since Gordon's telephone call on the preceding Friday, Brinco signed Voting Trust Agreement No. 1 as required by Hydro-Québec. With that, short of Hydro-Québec taking control of CFLCo's board and possibly obtaining majority ownership, there could be no going back.

#### 4. *Some questions*

Thus, as far as the two contracting parties were concerned, both understood the implications of the renewal clause at the time. Hydro-Québec recognized that two mills 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 in 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, raise 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 – leads to the question of whether economic duress, or its equivalent in Quebec law, which governs the contract, was at play.

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80. "Quebec claims 'important concessions'.... Churchill contract gets green light," *Evening Telegram* (15 July 1968) 3.

81. "What's in it for us?" *The Evening Telegram* (16 July 1968) 6.

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 fifty to seventy-five 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.

#### *IV. Project completion and thereafter*

Following the July 1968 announcement of the agreement, CFLCo's main tasks were to continue work to meet Hydro-Québec's schedule and to arrange commitments for the major financing. Under Voting Trust Agreement No. 1, CFLCo had to raise at least \$515 million before year's end or control of the project and, possibly, majority ownership would pass to Hydro-Québec.

In the interim and for most of the rest of the year, CFLCo would be financed by the funds raised in the \$25 million share issue that was initiated in July and was limited to the existing shareholders. Brinco took only about \$5 million in those shares, and even to do that it had to seek a loan from the Bank of Montreal. A reluctant bank agreed to this only when Brinco produced a letter from Rio Tinto-Zinc confirming that a rescue plan for Brinco was in the works.<sup>82</sup>

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. Later in the year Hydro-Québec purchased all the general mortgage bonds issued by CFLCo. Those bonds were for a total of \$100 million, earning an annual interest rate of 7.5%, and included one million bonus shares in CFLCo. Once complete, the effect of these transactions was the following ownership:

Brinco	57.0%
Hydro-Québec	34.2%
Newfoundland	8.8%

The remaining elements of CFLCo's financing plan, namely, commitments for all the first-mortgage bonds and a loan agreement with

82. See letter dated 5 July 1968 from G. Arnold Hart, the Bank's chairman and chief executive officer, to Donald Gordon, LAC, CFLCo Papers, MG28, III, 73, vol. 63, file 700.029.

a consortium of Canadian banks, were successfully in place by the fall of 1968. Having completed the financing and ratified by-law 13, CFLCo fulfilled the conditions of Voting Trust No. 1, and so it was terminated in October.<sup>83</sup>

The contract continued to be redrafted into the early months of 1969 but the changes were technical and legalistic. Finally, on May 12, 1969 at Hydro-Québec's offices in Montreal the contract was signed. Jean-Claude Lessard and Yvon De Guise, signed for Hydro-Québec. Signing for CFLCo were Donald McParland and Eric Lambert.

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 embarked on a different approach to hydroelectric development. After threatening expropriation of Brinco, it reached an agreement in 1974 to purchase Brinco's water rights on the lower Churchill River and its shares in CFLCo. This meant that the provincial government, through its Newfoundland and Labrador Hydro Corporation, came to own 65.8% of CFLCo and Hydro-Québec continued to hold its 34.2% stake, and CFLCo attained the status of a crown corporation.

It was not long after the ownership change that Newfoundland challenged the contract. First, it wanted to recall more Churchill Falls power than permitted in the contract and initiated court action on this matter in the mid-1970s. Secondly, as energy prices peaked in the 1980s, and following requests to Hydro-Québec to renegotiate terms, the provincial government passed the *Water Rights Reversion Act* which was aimed at invalidating the contract by recalling the water rights that had been leased to CFLCo; as a prerequisite to proclaiming that Act, the provincial government referred it to the courts to test its constitutional validity. Both challenges failed in the Supreme Court of Canada in the 1980s.<sup>84</sup>

Interestingly in 1979, some eight years after his political defeat, Smallwood wrote an apologia on his controversial twenty-two-year premiership. There he briefly dealt with the renewal clause. In contrast to the "pretty cheap power" remark he had made in 1968, he defended the

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83. It was automatically replaced by Voting Trust Agreement No.2, which also gave Hydro-Québec the right to replace the majority of CFLCo's Board and to take majority ownership in CFLCo under specified circumstances.

84. *Supra* note 1.

renewal clause as “fair” and “quite conventional.”<sup>85</sup> On the other hand, John Crosbie, a leading opponent to Smallwood’s political dominance in the late 1960s, has a different perspective. While Crosbie does not deal specifically with the renewal clause, he claims that the Churchill Falls project was driven by Smallwood’s “ego and grandiose projects dreams for Newfoundland” and implies that all the blame for the lack of any benefits lies with Smallwood.<sup>86</sup> Crosbie further discredits Smallwood by highlighting that he, with money lent to him and two associates by the Bank of Montreal, had been trading in Brinco shares when the CFLCo contract was being negotiated.<sup>87</sup> The facts are that Smallwood was not party to the contract’s negotiation and, more specifically, was not told of the huge concession on the renewal clause until the day it was publicly announced. At that point, whether he thought of intervening, what his personal and political motivations were, and whether he fully understood the implications, are unknown.

### *Conclusion*

The renewal clause in the 1969 Churchill Falls contract will have immense consequences. It ensures that from 2016 to 2041 all the economic rent associated with CFLCo’s electricity sales to Hydro-Québec will accrue to Hydro-Québec. The value of that economic rent is likely to be enormous. Yet, surprisingly, the origins of that renewal clause have been almost completely unknown until now.

This research is the first systematic and comprehensive investigation of the renewal clause. Hitherto unknown documents were located and used along with archival information for this purpose. Integrating that information in the context of the negotiation process sheds new light on the events that led to such an extraordinary contractual obligation. The findings raise questions of conflict-of-interest, economic duress, and business ethics. As the renewal date approaches, both the manner in which the renewal clause came about and the one-sided outcome of that clause ensure that the Churchill Falls Contract will again be a matter of serious dispute involving political and legal dimensions.

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85. Joseph Smallwood, *The Time has Come to Tell*, (St. John’s: Newfoundland Book Publishers, 1967) at 101.

86. John Crosbie, *No Holds Barred: My Life in Politics* (Toronto: McClelland & Stewart, 1997) at 101 and 127.

87. *Ibid.* at 133.

## 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.*

S 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:*

- *1<sup>st</sup> 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.

(2.)

Observation - 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.

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The Draft Contract Provisions

- 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 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 -

today's costs --->

Defeats purpose

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Notes:

1. Items in italics correspond to the hand-written notes and symbols.
2. Bolded italicized words are ones for which the handwriting was not clear so they are best guesses.

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

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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 costs - 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 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.

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Notes:

1. "DJM" refers to Donald J. McParland.
2. Bolded italicized words are ones for which the handwriting was not clear so they are best guesses.

