Legal Options:

S92A, Good Faith and Regulatory Proceedings in Quebec

Department of Natural Resources

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Newfoundland Labrador

Key Factors

- The province has engaged in extensive litigation over the years in relation to the Upper Churchill, none of which has been successful.
- While Section 92A of the Constitution Act could allow for the recall of Upper Churchill power, this could result in a breach of the 1969 Power Contract between Churchill Falls (Labrador) Corporation Limited ("CFLCo") and Hydro-Quebec ("Power Contract") under Quebec civil law and potentially result in billions of dollars in damages.
- The desired result of the good faith action is a change in the pricing terms of the Power Contract which will result in CFLCo receiving more revenue from the sale of Upper Churchill power, and the case will take years before it is resolved. The good faith action will not result in Upper Churchill power being returned.
- Nalcor has taken two applications for review in Quebec before the Regie (the Quebec equivalent of the PUB) for open access to transmit power from the Lower Churchill across Quebec. The Regie has refused these applications.

Introduction

The province of Newfoundland and Labrador has taken numerous legal actions in relation to the unfairness and inequity of the Upper Churchill contract. This paper outlines the province's actions including the litigation history associated with the Upper Churchill contract, the historical context and application of Section 92A of the Constitution Act, the good faith action, and actions before the Régie de l'énergie.

1. Litigation History

In 1927, the Judicial Committee of the Privy Council established the boundaries of Labrador in place today.[1] In fact, Quebec has never accepted the validity of this decision despite a review by a leading authority in Quebec in 1963 that Quebec's official silence and political inaction hampered any future argument that the border should be changed.[2] Also, as pointed out by Jason Churchill, two former Quebec premiers (Premier Taschereau in 1927 and Premier Lesage in 1956) made public comments accepting that Labrador belonged to Newfoundland.[3] In any event, this boundary was confirmed as the provincial boundary between Newfoundland and Labrador and Quebec in the Canadian Constitution in 1949.

In August 1976, the Government of Newfoundland and Labrador requested that CFLCo deliver 800 MW of power to Newfoundland and Labrador Hydro. In 1988, 12 years after the legal action had originally commenced, the Supreme Court of Canada ruled that Newfoundland and Labrador could not recall 800 MW from the Upper Churchill based on the alleged need for additional power in the province.[4] All levels of court concluded that CFLCo's water rights lease meant Newfoundland and Labrador could not demand that CFLCo deliver the requested power when CFLCo had already committed that power to Hydro-Quebec under the Power Contract.

In response to the original power recall demand, Hydro-Quebec started a parallel legal action in Quebec seeking confirmation of CFLCo's obligations under the Power Contract. In 1983 and 1985, both the Quebec Superior Court and the Quebec Court of Appeal confirmed that CFLCo had a binding obligation to deliver all power to Quebec other than power from the Upper Churchill already provided to Newfoundland and Labrador. The Court's reasoning included a finding that CFLCo could not rely upon the clauses in the Power Contract that relieved it of its delivery obligation in the event of a government action (the "force majeure" clause). The Court held that such a clause only applied to unforeseeable events. The right of the Province under Clause 2(e) of CFLCo's Water Lease to demand the delivery of power was known when the contract was negotiated. Therefore, the Province's use of that clause was not unforeseeable and not an event of force majeure.[5] In 1988, the Supreme Court of Canada ruled that its finding that the recall request was invalid meant that the issues in the Quebec litigation were moot (no longer a relevant dispute) and the appeal was dismissed.

In 1981, while the recall case was still before the courts, the Province passed the *Upper Churchill Water Rights Reversion Act* (the "WRRA"). The purpose of the WRRA was to revert ownership and control of the Upper Churchill development to the Province. It purported to cancel all of CFLCo's water and land rights, reverting the Upper Churchill development to provincial ownership. In 1984, the Supreme Court of Canada (SCC) overturned a Newfoundland and Labrador Court of Appeal decision and found that the WRRA was unconstitutional.[6] The SCC found that the actual purpose of the legislation (its "pith and substance") was to attack and terminate the Power Contract. However, as the Power Contract was governed by the laws of Quebec, it was outside the jurisdiction of Newfoundland and Labrador. The SCC found that the WRRA was a colourable or unconstitutional attempt to interfere with legal rights outside the jurisdiction of Newfoundland and Labrador and, as a result, was unconstitutional.

2. Historical Context of Section 92A

"Section 92A" refers to section 92A of the *Constitution Act, 1867*, and it was added to the Act in 1982.

Section 92A was an addition to the provisions of the Constitution which divide legislative powers between Canada and the provinces. The wording of section 92A was negotiated as a solution to disputes between Canada and the provinces about the authority of the provinces over their energy industries, and where the provincial authority ended and Canada's began. This dispute had been caused in part by the SCC decisions in the 1970s that had, on a number of occasions, struck down attempts by the provinces to regulate their energy industries. The result of these decisions was significant discontent in the provinces who perceived their constitutional authority was being eroded in favour of the federal government.

In response, section 92A was intended to confirm provincial authority in a number of areas. It clarified existing powers and added new ones regarding provincial regulation of energy industries, including the management and control, taxation, and export of energy assets.

Recall of Upper Churchill Power

Since 1982, various suggestions have been made as to how Newfoundland and Labrador might use the powers provided under section 92A to gain access to electricity from the Upper Churchill. One proposal is that the Government of Newfoundland and Labrador use the powers provided by section 92A to require CFLCo to deliver enough of the Upper Churchill's hydroelectric production to meet the future energy needs of the province. In the context of the debate around the proposed Muskrat Falls development, it is suggested that this is an alternative to Muskrat Falls. Further, it has been suggested that the price that would have to be paid for such power, if any, would be so low that this option would be superior to the economics of the proposed Muskrat Falls development.

Challenges with Access to Power

Any use by the Government of section 92A to access power from the Upper Churchill hydroelectric development would have to pass three tests in order to be feasible. First, the mechanism (whether it was legislation, regulation etc.) would have to be upheld by the courts as being constitutional. Second, the cost of the electricity involved would have to be low enough to make it preferable to other options. Finally, the mechanism would have to provide now the required level of certainty to Government and Nalcor that the power would be delivered as and when required.

Since any use of section 92A is expected to lead to prolonged litigation, the third test cannot be satisfied in the time frame necessary to meet the expected electricity demands of the province and to forego any other alternative, such as the proposed Muskrat Falls development. However, the use of Section 92A would also have difficulty in meeting the second of the first two tests in any event.

In order to be constitutional, the purpose and objective of legislation must be found by the courts to deal with issues within a province's constitutional authority, which was expanded and confirmed by section 92A. Such issues would include meeting projected energy requirements of the province generally, or specifically of industrial development in Labrador. As a result, legislation requiring the delivery or redistribution of such power from sources such as the Upper Churchill for these purposes could be constitutionally valid, as long as it could be shown to be clearly based upon and supported by such a rationale, even if such actions indirectly interfered with the Upper Churchill power contract. What the Province cannot do, as shown by the *Water Rights Reversion Act* case reviewed above, is to enact legislation and engage in conduct which is found by a court to be for the purpose of such interference and not for a valid provincial purpose. Assuming this would not be the case, constitutionality should not be an issue.

The second issue, the financial implications of valid access legislation, is more problematic. Any access request large enough to be a feasible alternative to the Muskrat Falls development will result

in CFLCo not being able to also meet its delivery obligations under the Power Contract. The issue therefore then becomes what CFLCo's obligation to Hydro-Quebec would be in such a circumstance. In previous litigation in Quebec relating to the "Recall Case," also described earlier in more detail, the Quebec Courts found that CFLCo would be in breach of the Power Contract if it failed to deliver, even if in response to a demand for power from the Province.

If a court followed this reasoning, CFLCo would be in breach of the Power Contract once it started diverting power to Newfoundland and Labrador from Hydro-Quebec. In these circumstances, Hydro-Quebec would pursue monetary damages from CFLCo. The amount of such damages cannot be accurately predicted, but would be significant. This is because the purpose of such damages will be to place Hydro-Quebec in the position they would have been in had CFLCo not breached the contract. There are a number of approaches to take in making such a calculation, as it would require identification of the losses suffered and profit lost to Hydro-Quebec as a result of the undelivered power. Attempts at this formulation can be made on a hypothetical basis. For example, a recall requirement of 800MW may result in approximately $180 Million payable to Hydro-Quebec annually solely in respect of the lost profit from sales at Quebec's internal electricity prices. If one included lost revenues from export sales that amount would increase significantly.

Any damages would then raise another issue - whether CFLCo would be able to pay such damages. Any level of damages would be expected to drive CFLCo into insolvency and likely bankruptcy, unless 1) CFLCo was paid sufficient amounts for its redirected power in the province to meet Hydro-Quebec's damages demands or 2) Hydro-Quebec or the Province injected sufficient funds into CFLCo to keep it solvent. In other words, the power delivered would not be free in the province, but instead may be priced at rates entirely out of the control of the Province.

Summary

While section 92A may provide a means to obtain access to part of the power of the Upper Churchill, there is no certainty that any attempt would be successful, or what the cost of such power would be.

Reliance on 92A would inevitably result in prolonged litigation. This litigation would take years to resolve (previous cases took as long as 12 years) and, even if ultimately successful, would do nothing to satisfy the province's need for power in the near future. This delay in litigation makes any reliance on 92A an infeasible means to replace Muskrat Falls.

Due to the uncertainty involved in implementing Section 92A, the government, even if it chose this route would still need to develop Muskrat Falls or refurbish Holyrood to meet the province's energy needs in the near future.

Also, even if 92A could be used to recall power, Newfoundland and Labrador could still be in breach of the power contract which is governed by the laws of Quebec. While the exact amount of compensation is unknown it can be reasonably expected to be in the billions of dollars.

3. "Good Faith" Action

The good faith action is based on the overriding Quebec civil law obligation for parties to act in good faith and not to abuse their contractual rights. The argument is that given the dramatic and unforeseen change in circumstances in the value of energy, and the current large disparity in the benefits received by the parties to the Power Contract, there is an obligation for Hydro-Quebec to renegotiate the pricing terms of the Power Contract in order to ensure a more equitable sharing of the benefits.

There is also an alternate remedy sought, being resiliation (cancellation) of the Power Contract for the future, but it is very unlikely that power will be returned. However, this remedy would only become operational in the event the court concludes that there has been a breach by Hydro-Quebec to renegotiate the price terms of the Power Contract, but finds that it does not have the power to impose new terms on the parties. The principal remedy sought is renegotiation of the price, which would have no impact on the availability of Churchill Falls power.

CFLCo, the corporation which owns the Upper Churchill hydroelectric development and which is owned approximately two-thirds to one-third by Newfoundland and Labrador Hydro and Hydro-Quebec has taken legal action against Hydro-Quebec. This legal action was started in the courts in Quebec in February 2010.

In the context of the debate and discussion over the Muskrat Falls project, some commentators have suggested that this Quebec litigation may be an alternative to the proposed Muskrat Falls development. Some have even suggested that Muskrat Falls be delayed until it is determined if this legal action will succeed.[7] The assumption behind such statements appears to be that the litigation is principally about accessing power or altering CFLCo's electricity deliveries under the power contract.

These comments are incorrect. The litigation is about the price being paid by Hydro-Quebec to CFLCo under the Power Contract and CFLCo's request that the price be changed. This litigation is independent of, and unrelated to, a decision to proceed with the Muskrat Falls development.

Details of the Litigation

On 23 February 2010, CFLCo commenced a legal action against Hydro-Quebec in the Superior Court of Quebec. This action first seeks an Order from the court modifying the pricing terms of the Power Contract to provide CFLCo with a more equitable revenue stream.

CFLCo's position is based on the civil law obligation of good faith in the negotiation and execution of contracts, and particularly long-term contracts. CFLCo's claim is that the economic and legal context that existed when the power contract was negotiated in the late 1960s has changed, with an immense and wholly unforeseen increase in energy prices in the years following execution of the Power Contract, the emergence of competitive energy markets, legislative changes granting Hydro-Quebec the authority to export power, and the availability of access to the Quebec transmission network as a result of the implementation of U.S. open access transmission requirements. CFLCo's claim is that these changes have been so drastic that the good faith principle requires that Hydro-Quebec renegotiate the pricing under the Power Contract for its remaining term (including the renewal term from 2016 to 2041), and given Hydro-Quebec's refusal to do so, that the court impose new pricing terms.

It has asked the Quebec court for an order that the Power Contract be changed to provide that Hydro-Quebec pay CFLCo a price for electricity determined by a formula which combines Hydro-Quebec's revenues from its intra-provincial and export electricity sales. If the action is ultimately successful, the new pricing structure would apply as of November 2009, the date upon which CFLCo formally requested Hydro-Quebec renegotiate the terms of the Power Contract on this basis. Hydro-Quebec filed a defence to this action in May 2011. The pre-trial litigation processes are proceeding and the matter is expected to go to trial in Quebec in the fall of 2013.

Appeals can be expected, regardless of the result, including possibly an appeal to the Supreme Court of Canada. This would likely take at least 5 years before the issue could be finally determined. Therefore, apart from the risks inherent in any litigation, the delay before a successful result is substantial.

Summary

The Quebec litigation represents an opportunity for CFLCo to remediate the future pricing disparity of the Power Contract but it does not represent a means to solve the province's future energy demand requirements. Its discussion in the context of being an alternative to the Muskrat Falls development is misplaced and the good faith action cannot be the basis of a decision to forego development of Muskrat Falls at this time.

4. Actions Before the Regie (Quebec's PUB)

Introduction

Since discussions began on the development of the Upper Churchill, Newfoundland and Labrador has been seeking transmission access through Quebec to Ontario and New York markets for the electrical generation potential of the Churchill River. At the time of the Upper Churchill negotiations there was no regulatory mechanism either in Canada or in the United States to compel the government of Quebec to allow transmission access.

Since that time, there have been many legal and commercial avenues sought to unlock the geographic stranglehold that Quebec has on developments on the Churchill River. Both the Gull Island and Muskrat Falls projects have been long identified as two of the best undeveloped hydroelectricity projects in Canada.

In 1996, the U.S. Government, through the Federal Energy Regulatory Commission (FERC), changed the way that electricity is transmitted and sold in the United States. Prior to this change, large integrated generation and transmission utilities were able to exercise monopoly control over large geographical areas by restricting access to their transmission and distribution grids. These utilities had an unfettered ability to generate electricity and sell it to markets with limited competition to control electricity prices.

The new model for the electricity markets requires that all transmission owners provide non-discriminatory access and comparable transmission service to anyone who wants to sell electricity but requires transmission access. In order to facilitate and regulate this market, FERC requires that all transmission providers publish an Open Access Transmission Tariff (OATT) that gives all potential users a transparent view on the access requirements. The purpose of an OATT is to ensure that third parties are provided transmission service by a transmission provider. The principles of openness and non-discrimination are intended to be inherent in the "Open Access process." The ultimate objective is to ensure a level playing field for all generation providers and power marketers to access the grid and compete on a fair basis to sell their power in the markets.

Failure to issue an OATT or follow the standardized access rules will result in sanctions being imposed by FERC. It is worthy to note that, FERC only has full regulatory authority over U.S. markets and companies. Canada does not have any similar type of open access requirements. However, as most Canadian provinces engage in electricity trade in the U.S., almost all provincial utilities have adopted an OATT and open access rules to ensure their ability to export electricity to the larger U.S. markets.

Armed with the understanding that open access provisions would apply and with a plan to develop Gull Island, Newfoundland and Labrador Hydro made two transmission access applications in 2006 for access through Quebec to Ontario, New York, New England and New Brunswick. To date, these applications have not received the treatment required under the open access rules, and Quebec continues to obstruct Newfoundland and Labrador's attempts to develop the Lower Churchill.

Hydro-Quebec TransÉnergie (HQT) is the division of Hydro-Quebec (HQ) responsible for the operation of HQ's transmission system and management of power flows on the system in accordance with HQ's OATT and North American reliability standards. In order to participate in U.S. competitive wholesale markets, the government of Quebec adopted an OATT in 1997 to govern HQT actions.

In accordance with the OATT, a Transmission Provider is obligated to provide long term transmission service for a complete, accepted application. The OATT provides a complaint procedure in the event that a transmission customer disputes the application of the OATT by the transmission provider. In accordance with this process, issues in dispute are brought to the Régie de l'énergie for a hearing.

The Régie de l'énergie is an economic regulatory agency established by the National Assembly of Quebec (Quebec Provincial legislature) to establish and modify the rates and conditions for the transmission and distribution of electricity in Quebec. The Régie is the equivalent of Newfoundland and Labrador's Board of Commissioners of Public Utilities (PUB). The Régie is also responsible for examining complaints by transmission customers.

Since January 19, 2006, Newfoundland and Labrador Hydro (NLH) has made two transmission service applications to Hydro-Québec TransÉnergie (HQT) in accordance with its OATT for capacity for the Lower Churchill Project.[8] The application was for a maximum of 2824 MW, the combined capacity of Gull Island and Muskrat Falls.[9] These applications with HQT have led to 2 hearings before the Regie, both of which have been unsuccessful.

Application 1

On January 19, 2006, NLH made an application for transmission service to HQT for up to 2,824 MW of capacity into Québec and to the Ontario, New Brunswick, New England and New York markets for deliveries from the Lower Churchill project for 30 years starting in 2015. This application was accepted and HQT undertook a systems impact study - the first study phase for a service request. NLH disagreed with HQT's interpretation and application of its OATT in the preparation of this study and subsequently filed three complaints with the Régie.

The Régie rendered its decision on May 25, 2010 and ruled against Nalcor on all issues.

Application 2

On February 5, 2007, NLH made a second application for 724 MW of transmission capacity relating to deliveries from the Lower Churchill to complement the first application and to increase deliveries into New Brunswick and New England. This application was initially accepted, but subsequently HQT unilaterally decided that NLH had made a "substantial change" to the request and therefore processed it as a new request resulting in a loss of priority. NLH protested HQT's action and HQT reinstated the priority, but NLH proceeded with a complaint to the Régie for regulatory interpretation because HQT refused to acknowledge its misapplication of the OATT that led to the loss of priority. The application to the Regie was dismissed.

NLH Application for Judicial Review of Regie Decision on Application 1

On May 6, 2011, NLH filed an application for judicial review with the Superior Court of Quebec for a review of decisions made by the Regie de l'energie against NLH on complaints filed by NLH against Hydro-Quebec Transenergie (HQT). A decision of the Regie cannot be appealed. However, an application for judicial review can be made on limited grounds.

The parties have made procedural filings and a judge has been assigned to the case. A court date has been set for January 2013. The hearing is expected to last a few days. There will be no witnesses and no new evidence. NLH is seeking to quash the Regie decisions.

The complaints by Nalcor/NLH to the Regie boil down to one very simple question: Does Hydro-Quebec provide fair and reasonable access to its transmission lines as it is supposed to do under its own rules which they adopted from the U.S?

Summary

The availability of open access markets and transparent regulatory frameworks in the United States for the transmission of electricity should provide an opportunity for Nalcor to access export markets. These regulatory frameworks are not enforceable within Canada and, while Hydro-Quebec must adhere to these rules as they apply to its electricity trade in the United States, the same degree of transparency is not required for electricity trade within Canada. Nalcor has attempted to gain access through the transmission system for the Lower Churchill Project. These efforts have not proved successful, resulting in regulatory rulings, appeals and ultimately a court challenge.

5. Conclusion

The province of Newfoundland and Labrador has taken numerous legal actions in relation to the unfairness and inequity of the Upper Churchill contract, none of which has been successful to date. Also, as outlined earlier, the province has explored the use of section 92A to recall Upper Churchill power but the risk inherent in the process would not allow for the use of section 92A to meet Newfoundland and Labrador's present energy needs.

Also, contrary to the suggestion of some, the "good faith" action, even if ultimately successful, would not likely result in the ability to recall, or the return of, Upper Churchill power.

Finally, since 2006, Nalcor/NLH has attempted to gain access for Lower Churchill power through Quebec's regulatory process but has had no success.

It is clear that there has been no political will in Quebec to work with Newfoundland and Labrador and allow the province to break the geographical stranglehold that Quebec has on the province. Former Federal and Provincial Cabinet Minister John Crosbie stated in a speech in 2003 that Muskrat Falls and Gull Island had not been developed due to the lack of a national energy strategy "and the unshakably self-centered position taken by Quebec where Newfoundland remains in a vise with little bargaining power."[10] The events of the last 40 years support the truth of Mr. Crosbie's statements.

Footnotes

1 Re Labrador Boundary [1927] 2 DLR 401 (J.C.P.C).

2 Henri Dorion – "The Quebec-Newfoundland Boundary" 1963.

3 Jason Churchill – "Pragmatic Federalism: The Politics Behind the 1969 Churchill Falls Contract." Newfoundland Studies 13 and 15, no.2.

4 [1988] 1 S.C.R. 1085.

5 (1985), 20 Admin. L.R. 269 (QCCA).

6 [1984] 1 S.C.R 297.

7 Newfoundland and Labrador Board of Commissioners of Public Utilities, Review of Two Generation Expansion Options for the Least-Cost Supply of Power to Island Interconnected Customers for the Period 2011-2067 (St. John's, 30 March 2012) at pages 23 and 24.

8 The applications were made by NLH prior to the creation of Nalcor Energy. Any transmission rights potentially obtained could have been transferred to Nalcor Energy or a future Nalcor subsidiary operating Lower Churchill. The complaints process is managed by Nalcor Energy.

9 The capacity of Gull Island was increased from 2000 MW to 2250 MW subsequent to the application.

10 Speech of the Honourable John C. Crosbie, delivered in St. John's on January 31, 2003.

Department of Natural Resources
Natural Resources Building
50 Elizabeth Avenue, P.O. Box 8700
St. John's, NL A1B 4J6
709.729.3017

www.gov.nl.ca

Newfoundland Labrador