Provincial Budget Briefs

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NEWFOUNDLAND AND LABRADOR BUDGET 2018

Newfoundland & Labrador's budget deficit is being reduced, with the continued target of balance by 2022/23. Near-term deficit projections, including the $683mn for upcoming 2018/19, are a little higher than they were in last year's budget, and the risk adjustment is slightly smaller. However, it should be noted that Budget 2018 uses fairly conservative forecasts for oil prices and nominal GDP, and as such there's scope for improvement beyond what is budgeted for. After seeing a large reduction in 2017/18, net new bond issuance is expected to be fairly stable at $1.2bn in the upcoming 2018/19 fiscal year. Net new borrowings for the duration of Newfoundland & Labrador's 2022/23 fiscal plan is increasing by $1.4bn from last year's budget, of which $1.1bn is due to changes in cash flows related to Nalcor Energy.

Table 1

$Millions	2016/17 Actual	2017/18 17 Budget	2017/18 18 Budget	2017/18 Change	2018/19 18 Budget	2019/20 18 Budget	2020/21 18 Budget	2021/22 18 Budget	2022/23 18 Budget
Revenue	**7,157**	**7,339**	**7,340**	**1**	**7,673**	**7,760**	**7,527**	**7,833**	**8,049**
Fiscal Revenue	6,706	6,898	6,966	68	7,244				
% change	*18.1*	*2.9*	*3.9*	*1.0*	*4.0*				
Net Income: Govt. Bus. Ent.	451	441	374	-67	429				
Net Expenditures	**8,305**	**8,116**	**8,152**	**36**	**8,356**	**8,242**	**8,146**	**8,006**	**7,908**
Program Spending	7,349	7,004	7,183	179	7,349				
% change	*0.9*	*-4.7*	*-2.3*	*2.4*	*2.3*				
Public Debt Charges	956	1,112	969	-143	1,007				
Revenue Risk Adjustment	-	0	0	0	0	-25	-35	-70	-85
Adj. Surplus/(Deficit)	**-1,148**	**-778**	**-812**	**-34**	**-683**	**-507**	**-654**	**-243**	**56**

Economic Clouds Closer to Clearing

Having been hit by the aftereffects of low oil prices, ending of large projects and fiscal restraint in 2017, the track of Newfoundland's economy is gradually set to improve. Following an estimated 3.7% decline in real GDP during 2017, the economy is anticipated to contract by a more modest 0.8% in 2018 before showing some growth in 2019.

The economic forecasts are based off fairly conservative forecasts for oil prices. Brent oil is assumed to average $63bbl during the upcoming 2018/19 fiscal year and the one after, before rising gradually after that. That's a fair way below the current spot price ($70/bbl) and the calendar year-to-date average ($67/bbl). Given the fiscal sensitivity of revenues to oil prices, with $1/bbl shown to be worth about $20-$25mn, the Province should be well positioned to beat on their fiscal plans even if oil prices just remain at current levels.

The conservative oil price assumptions also add prudence to the forecast through the projections for nominal GDP, which is expected to rise by only 1.3% this year following a 4.2% gain in 2017. Indeed, the average growth rate for nominal GDP over the whole forecast horizon (just over 2%) is almost a percentage point lower than the assumptions used in Budget 2017.

Table 2	Key Assumptions			
Y/Y % Chg	**2017**	**2018**	**2019**	**2020-22**
Economic Assumptions				
Real GDP	-3.4	-0.8	1.1	0.3
Nominal GDP	4.2	1.3	1.8	2.6
Employment	-3.7	-1.0	-1.8	-0.5
Unemployment Rate (%)	14.8	14.8	15.4	15.3
Household Disposable Income	-0.6	-1.3	-1.6	-0.3
Retail Sales	1.6	-0.5	-1.9	-0.5
Housing Starts (K)	1.4	1.3	1.2	1.3
Real Capital Investment	-25.4	-10.8	-10.4	-5.1
CPI	2.4	2.0	2.2	2.2
Population	-0.3	-0.6	-0.5	-0.5
Financial Assumptions (Fiscal Yr)	**17/18**	**18/19**	**19/20**	**20/21-23/24**
Brent Oil (US$/bbl)	57.2	63.0	63.0	72.0
Exchange Rate (US$/Cdn$)	0.78	0.79	0.80	0.81

Note: 2020-22 and '20/21-23/24 are averages

Remaining on Track for 2022/23 Balance

The deficit for outgoing 2017/18 is now projected to be $812mn, up slightly from the $778mn projected a year ago. Revenue came in virtually bang on expectations, despite an undershoot for government business enterprises. Overall spending was $36mn higher than forecast – a modest overshoot given the sharp reduction targeted. Program spending was trimmed, although the 2.3% decline was around half the proposed reduction. That is largely offset by lower interest expenses than had originally been budgeted for.

Linked to efforts to reduce headcount and lower salary expenses inside government, the revised 2017/18 number also includes $37mn in severance expenses under the new collective bargaining agreement. The remaining $52mn for this one-time severance expense is included in projections for the upcoming 2018/19 fiscal year.

Budget 2018 projects a deficit of $683mn for 2018/19. After a couple of years of tough restraint, program spending is projected to rise by a modest 2.3%. Changes in auto insurance and other taxation also provide some slight tax relief to households. The Temporary Gas Tax will continue to be phased out, with further information expected when the province releases details on its carbon tax later this spring. Fiscal revenue is expected to rise 4% in 2018/19, with a rebound in net income from government business enterprises also helping overall revenue.

Over the longer term, the deficit is expected to remain larger in 2019/20 and 2020/21 than was the case in Budget 2017, before making more noticeable progress towards a 2022/23 surplus. The projections continue to make an adjustment for revenue risk related to oil prices, with that allowance rising from $25mn in 2019/20 to $85mn in 2022/23. While that adjustment is smaller than in Budget 2017 (when it was $50mn rising to $140mn), as stated previously, Budget 2018 uses conservative forecasts for oil prices relative to the current spot rate.

Credit Trends Showing Improvement, but Still a Long Path to Repairing the Balance Sheet

Newfoundland & Labrador's steadfast commitment to controlling spending is impressive. The Government Renewal Initiative, which was introduced in the 2016/17 budget, aimed to identify potential options to reduce spending by 30% over three years. Now with much higher oil prices helping revenues, there is increased optimism that the path to balance is more secure towards the 2022/23 target. However, we take note that net new borrowings for the duration of Newfoundland & Labrador's 2022/23 fiscal plan is increasing by $1.4bn from last year's budget. Moreover, with an election tentatively scheduled for on or before October 8, 2019, additional measures to restrain spending will be difficult to implement.

Notwithstanding the more secure path to balance, the Province projects that net debt as a percentage of GDP will continue to climb and peak only in 2020/21 at just under 50%. A stronger economy, restrained spending and lower debt accumulation from capital projects has resulted in a much better trajectory than envisioned in Budget 2016 when that ratio was expected to reach close to 58%.

Table 3			
$Millions	**2016/17A**	**2017/18E**	**2018/19F**
Borrowing Requirements			
Budgetary (Surplus)/Deficit	1,148	812	683
Investment in Capital Assets	271	498	487
Other Non-Cash Items	-801	48	-200
Net Investments	1,060	604	745
Retirement of Debt	1,443	150	148
Total	**3,121**	**2,112**	**1,863**
Sources of Funding			
Cash Balances & T-Bills	195	937	413
Bonds & MTNs	2,926	1,175	1,450
Total	**3,121**	**2,112**	**1,863**
Net New Issues			
Bonds & MTNs	2,926	1,175	1,215

As such, much work needs to be done to eventually reduce high debt levels in order to build financial flexibility against future oil price and other shocks. Announced plans to initiate the process to separate Nalcor Energy's oil and gas subsidiary into a stand-alone crown corporation may signal a step towards monetizing crown assets to reduce debt. Although hypothetical, this suggestion could extend to other Nalcor Energy assets, including Muskrat Falls.

The very expensive Muskrat Falls hydro-electric project also remains a large contingent risk. There is uncertainty as to whether a portion of the costs of the project will need to be included in tax supported debt. The Province is still required to make more equity investments in Nalcor Energy. This year, that investment will total $723.9mn towards the completion of the project, which is close to 90% complete and scheduled to produce power for domestic use in mid-2018. Full power should be reached in 2020. The Province's remaining equity (and/or reduced dividend) requirements to 2020 are estimated at $1.3bn, including this year's funding requirement.

Today's budget is likely to be modestly negative from a ratings perspective. S&P downgraded the province to A from A+ in 2016 and, at the same time, restored the outlook to stable. DBRS maintained its A(Low) rating throughout the oil downturn with Newfoundland & Labrador successfully restraining debt metrics within its rating criteria. Moody's is the only rating agency with a negative outlook and will likely continue to be cautious for the time being. It downgraded the Province to Aa3 negative from Aa2 negative in 2016. That rating agency's emphasis on implied federal support was validated on a couple of occasions, including when the federal government agreed to provide enhanced guarantees on additional funds to finance the Muskrat Falls project.

In an analysis of Newfoundland & Labrador's oil price sensitivity earlier this year, we highlighted that Newfoundland and Labrador's non-renewable resource revenue (i.e. oil offshore royalties plus mining tax and royalties) represent about 13% of total revenues. This is down significantly from close to 40% in 2012. With Brent oil performing better than plan, we saw little risk around the Province's projected 2017/2018 and 2018/19 deficit projections. We maintain this view.

Gross borrowing requirements are lower this year, down to $1.9bn in 2018/19 from $2.1bn in 2017/18. The drop stems from shrinking deficits and lower other non-cash items. Capital investments and debt retirement are relatively steady. With respect to the former, the Province is cautiously executing on its $3bn multi-year infrastructure plan (investment horizon 5 years).

However, planned issuance of Bonds and MTNs will increase to $1.5bn from $1.2bn due to a drawdown on cash from pre-borrowings and well as its commitment to reduce dependencies on short-term borrowings for long-term operations.

The Province's borrowings include borrowings on behalf of crown corporations, including Nalcor Energy (and subsidiary Newfoundland and Labrador Hydro) and Newfoundland and Labrador Municipal Financing Corporation. The Fiscal 2017/18 borrowing plan is $1.4bn, of which the Province has already borrowed $1.8bn. This implies $400mn in pre-borrowing against gross-borrowing requirements, which accounts for the drawdown in cash and T-bills. As such, it is our understanding that the drawdown in cash will not impinge upon the existing liquidity the Province maintains in support of its outstanding debt (i.e. sinking and other funds) and credit ratings.

In Budget 2017, the Province had originally projected borrowing requirements of $1.6bn in 2018/19. In today's budget, this has been reduced to $1.45bn. Net new borrowings for the duration of Newfoundland & Labrador's 2022/23 fiscal plan is increased by $1.4bn from last year's budget, of which $1.1bn is due to changes in cash flows related to Nalcor Energy.

Credit Ratings: DBRS A(Low) Stable, Moody's Aa3 Negative, S&P A stable