Provincial Budget Briefs

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MANITOBA BUDGET 2018

Solid economic growth in 2017, coupled with lower spending, sees Manitoba on course to post a smaller deficit than initially budgeted in the 2017/18 fiscal year. Its debt-to-GDP ratio, although rising, has also been reset to a lower set-point — both factors showing improving budgetary performance. The $726mn deficit now projected (vs $840mn previously) also includes a $50mn contingency. The deficit is expected to narrower further in 2018/19, to $521mn, thanks largely to increased transfers from the federal government. The government still plans to achieve a balanced budget by the end of a second term. As is common practice in Manitoba, the deficit projections include an in-year adjustment of $115mn, which could come from an improvement on either the spending or revenue side. Also in this budget is a $50mn allocation to the Fiscal Stabilization Fund. Although the deficit and borrowing requirements for crown corporations are lower this year, total gross borrowing requirements will increase to $6.4bn from $5.8bn due to higher debt maturities. However, as the province has already pre-funded $600mn, debt issuance year-over-year is expected to drop from $6.4bn to $5.8bn. Manitoba's improving budgetary performance is a positive credit factor, but risks remain at Manitoba Hydro as it executes a major capital development program.

Table 1

$Millions	2016/17 Actual	2017/18 17 Budget	18 Budget	Change	2018/19 18 Budget	2019/20 18 Budget	2020/21 18 Budget	2021/22 18 Budget
Revenue	**15,723**	**16,101**	**16,128**	**27**	**16,787**	**17,095**	**17,243**	**17,593**
Own Source	11,595	11,938	11,933	-5	12,291			
% change	*3.2*		*2.9*		*3.0*			
Federal Transfers	4,128	4,163	4,195	32	4,496			
Expenditures	**16,487**	**17,056**	**16,804**	**-252**	**17,423**	**17,598**	**17,638**	**17,850**
Program Spending	15,557	16,065	15,840	-225	16,389			
% change	*3.4*		*1.8*		*3.5*			
Public Debt Charges	930	991	964	-27	1,034			
Contingency For Writedown			50					
In-Year Adjustments/Lapse	-	115	-	-115	115	115	115	115
Summary Budget Balance	**-764**	**-840**	**-726**	**114**	**-521**	**-388**	**-280**	**-142**

Growth to Slow After Solid 2017

Manitoba's economic growth tends to be amongst the most stable in the country, not generally seeing the high peaks or low troughs of others. While 2017 was a better year than had originally been expected, particularly in nominal terms thanks to a recovery in commodity prices, the 2.2% real growth now estimated is only 0.2%-pts above initial expectations and below the national average. However, Manitoba's economy is expected to see only a modest deceleration this year, to 2.0% real growth in 2018. While a further slowing is expected in 2019, the 1.6% forecast would still be close to our projection for the national economy as a whole.

Employment in 2017 was a lot stronger than had initially been forecast, rising 1.7% versus the 0.7% expectation in last year's budget. While that's expected to ease going forward, the impact on household incomes and spending should be beneficial to the economy. Meanwhile, investments in food processing should also be supportive for growth in the future.

Table 2	Key Assumptions		
Y/Y % Chg	2017	2018	2019
Economic Assumptions			
Real GDP	2.2	2.0	1.6
Nominal GDP	4.3	3.8	3.5
Employment	1.7	0.8	0.5
Unemployment Rate (%)	5.4	5.3	5.3
CPI	1.6	2.1	2.1
Population	1.5	1.2	1.3

Deficits Continue to Gradually Narrow

The solid economic growth seen in 2017 appears to be translating into a modestly narrower deficit for the outgoing 2017/18 fiscal year. Even though personal income tax receipts are tracking a little lighter than had been originally budgeted for (at odds with strong employment growth) that is offset on the revenue side by better receipts in other areas such as retail sales tax. Federal transfers are also slightly larger, leaving overall revenue marginally above Budget 2017 projections.

Most of the improvement in 2017/18 compared to last year's budget was, however, due to lower expenditures. Of particular note, spending for agriculture is now estimated to be $228mn, against an original budget of $394mn. That undershoot alone accounts for about two-thirds of the $252mn spending savings versus Budget 2017. Overall, the $726mn deficit now projected for 2017/18 is $114mn less than originally projected and includes a $50mn contingency for writedowns.

The budget deficit is expected to narrow again to $521mn in 2018/19. As is the custom in Manitoba, that projection includes $115mn of in-year improvement that could come from the revenue or spending side (the deficit without that would be $636mn).

The main difference from 2017/18 to 2018/19 is expected to be transfers from the federal government, which jump by a little over $300mn to almost $4.5bn. That increase is linked to Manitoba moving forward with a Federal government mandated carbon tax. The tax of $25 per tonne of greenhouse gas emissions takes effect on September 1st and, on a full year basis, is expected to bring in an additional $248mn in revenue for the province.

That revenue will be partly used to provide tax relief for households and small businesses. Budget 2018 announced increases in the Basic Personal Amount (BPA) over two years which, by 2020, are expected to cost the Province $156mn. In terms of expenditure, the 3.5% rise in program spending would be an acceleration from 2017/18, however would still be marginally below the expected pace of nominal GDP growth.

The Province will make an allocation of $50mn to the Fiscal Stabilization Fund in 2018/19, up from $10mn in the outgoing year. That increases the size of the fund by about 40%, and adds some protection against future costly events such as natural disasters. The Province said it plans to make further payments to the fund in future years.

Lower Gross Borrowing Requirements and Debt Supply

In spite of shrinking deficits and lower combined borrowing requirements for Government Business Enterprises (i.e. Manitoba Hydro-Electric Board and Manitoba Liquor and Lotteries Corporation), Manitoba's gross borrowing requirements will increase in 2018/19 due to rising net maturities (i.e. net of sinking fund withdrawals). Total gross borrowing requirements will increase to $6.4bn from $5.8bn. However, pre-funding of $600mn will reduce remaining debt supply to $5.8bn. Supply in 2017/18, with pre-funding, was around $6.4bn, pointing to lower supply this coming year. We highlight that Budget 17 had an original borrowing requirement of $6.7bn for 2017/18 which was later reduced to $5.8bn.

Table 3	**Financing Plan**		
$Millions	**2016/17A**	**2017/18E**	**2018/19F**
Borrowing Requirements			
Core Gov't (Surplus)/Deficit	842	775	635
Transfer from Fiscal Stabilization Fund	0	0	0
Capital Investments	141	280	371
Funding Pension Liability	0	0	0
Pre-funding	-51	-600	0
Crown Corporations & Other	2,383	3,295	3,127
Net Financial Requirement	**3,314**	**3,750**	**4,133**
Gross Maturities & Calls[1]	2,741	2,499	2,697
Less: Sinking Fund Withdrawal	361	400	412
Net Maturities & Calls	2,379	2,099	2,285
Total Gross Borrowing	**5,693**	**5,848**	**6,418**
Funded to date			600
Net Funding Requirement	**5,693**	**5,848**	**5,818**
Sources of Funding			
T-Bills	0	0	0
Bonds & MTNs	5,693	5,848	6,418
Retail Products	0	0	0
CPP	0	0	0
Total	**5,693**	**5,848**	**6,418**
Net New Issues			
Bonds & MTNs	2,990	3,373	3,729

Manitoba Hydro accounts for substantially all of the $4.3bn in total crown borrowing requirements. Its borrowing requirements are $4.2bn, of which $2.7bn represent new cash requirements. Gross borrowing needs are slightly lower this year for the crown corporations. We highlight, however, that according to a rate application filing with the Manitoba Public Utilities Board (PUB), Manitoba Hydro's long-term debt is projected to ramp-up from an estimated $18.2bn at March 31, 2018 to a peak of $23.3bn by March 31, 2023 — an increase of $5.1bn. Moreover, there remains considerable risk around cost projections for two key hydro-electric and transmissions projects (Keeyask and Bipole III). This is explained in more detail below.

Manitoba estimates that in 2018/19, its borrowing costs will surpass $1bn for the first time, with a year-over-year increase of $70mn. The increase reflects a combination of higher borrowings ($50mn) and the impact of higher interest rates ($20mn). The province's sensitivity analysis indicates that the full-year impact of a 1% increase in interest rates could approach $100mn, with longer-term impacts greater with the compounding effects. The $1bn threshold is also highlighted as placing debt servicing costs as the fourth largest area of spending after health ($6.8bn), Education ($4.5bn), and family services ($2.1bn) and substantially greater than Justice ($0.7bn) and Infrastructure ($0.4bn). The province estimates that debt servicing costs will consume about 6.2% of total revenue. According to Standard & Poor's, however, which includes the debt of Manitoba Hydro, debt servicing costs are projected to be over 10% in the years ahead.

In the last couple of years, Manitoba has tapped the international markets for roughly 39% of its borrowing requirements (two year average with current year around 44% and previous year around 34%). The province does not have a formal foreign market borrowing target, but expects to do a meaningful percentage of international borrowing this year; taking advantage of international borrowing opportunities when funding is cost-effective. The province has funded in CAD, USD, EUR, JPY, HKD, GBP, and AUD, but substantially all foreign-dollar borrowings are swapped back to Canadian dollar. The weighted average term of Manitoba's debt is approximately 13.7 years, which has extended slightly from 13.1 years last year.

A Steady, Gradual Approach to Correcting the Course, but Risks Remain at Manitoba Hydro

We view today's budget as neutral from a credit perspective, and heading in the right direction. Following previous downgrades by Moody's and S&P (DBRS unchanged, but lowest of the three), we believe that the government's commitment to sustainable fiscal principles, evidence of making progress in trimming their deficit, and a planned return to balance at the end of their second term (i.e. 2024) will support current ratings and outlooks. However, there is insufficient progress and considerable risk surrounding Manitoba Hydro to change our view to credit positive. In 2016, when S&P downgraded the province, weak credit metrics at Manitoba-Hydro prompted a change by S&P to no longer consider the crown utility as a self-supporting entity. Low electricity rates and rising debt have kept its profitability and debt protection metrics weak.

Manitoba Hydro has some major milestones to achieve to reduce the high contingent risk facing the province. The Keeyask Generating Station and the integrated Bipole III Transmission Project, two interrelated projects, have been beset with cost overruns and delays. The most recent official estimate for the Keeyask Generating Station project— a 695 megawatt power dam on the Nelson River north of Winnipeg — is $8.7bn. It is expected to be in service in 2020/21. The project was originally estimated to cost $6.5bn and be in service in November 2019. It's unclear if more cost overruns and delays are ahead, which is discussed further below.

In a positive step to position Manitoba-Hydro on a more sustainable path, it has applied to the Manitoba Public Utilities Board for a rate increase. Its 2017/18 and 2018/2019 General Rate Application requests, on an interim and prospective basis, an across-the-board increase of 7.9% to all components of the rates for all customer classes effective April 1, 2018 until 2023/24; thereafter an additional 4.54% increase. Manitoba-Hydro has also embarked on a major cost restructuring program. However, as part of the rate review, an independent consulting report commissioned by the PUB has raised the possibility that the Keeyask Hydro Electric Project could cost as much as $10.5bn in a worst-case scenario— that would be $1.8bn higher than the latest projection. The Bipole III project costs overruns and delays have been less severe. The cost has been increased to approximately $5bn, according to the PUB rate application, from an original budget of $4.65bn. The project has been delayed 12-18 months from its original projection to a new estimated in-service date of July 2018.

Due to stronger economic growth and better than budgeted fiscal management reflecting sweeping performance and value-for-money reviews, Manitoba's net debt has been reset on a lower path with net debt-to-GDP projected to increase to 34.0% in 2017/18 and then increasing to 34.3% in 2018/19. Last year, the province was projecting a ratio of 35.7% in 2017/18, up from 34.5% in 2016/17. Although the province has provided operating projections to 2021/2022, it has not provided a long-term capital forecast or net debt ratio forecast. Therefore, it is not possible to determine when the province's debt ratio is expected to peak before it improves. We expect that the province will be rewarded by the capital markets (i.e. via their credit spreads) and the rating agencies, when there is clearer visibility with respect to Manitoba-Hydro and a longer track record of fiscal management by the current government.

Credit Ratings*: DBRS A(high) Stable, Moody's Aa2 Stable, S&P A+ Stable
*Ratings of the Province of Manitoba and guaranteed debt of crown-energy corporation, Manitoba Hydro-Electric Board