ECONOMICS
https://economics.cibccm.com

Provincial Budget Briefs

March 22, 2018

Maria Berlettano, CFA
(416) 594-8041

Andrew Grantham
(416) 956-3219

Tom Bognar, CFA
(416) 956-6032

ALBERTA BUDGET 2018

Alberta is making slightly faster progress than previously expected in reducing its deficit, with the just under $9.1bn shortfall for outgoing 2017/18 more than $1.4bn less than first budgeted for. The current large discount of WCS oil will weigh on resource revenue in the coming year, but despite that drag, some further improvement is expected. The $8.8bn deficit in Budget 2018 incorporates a $0.5bn risk adjustment. Near-term projections are based on fairly conservative forecasts for oil prices. However, the longer term projections that show the route back to balance by 2023/24, which were laid out for the first time, are fairly reliant on improvements in resource revenue. Alberta's borrowing requirements will remain elevated over the five-year forecast horizon, in spite of a projected narrowing of the deficit. This reflects large capital needs for infrastructure programs and refinancing. Alberta projects it will borrow long-term debt of $15.4bn in 2018/19, up from $13.5bn in 2017/18.

Table 1

C$Billions	2016/17 Actual	2017/18 17 Budget	2017/18 18 Budget	Change	2018/19 18 Budget	2019/20 18 Budget	2020/21 18 Budget	2021/22 18 Budget	2022/23 18 Budget	2023/24 18 Budget
Revenue										
Resource Revenue	3.097	3.754	4.534	0.780	3.829	4.183	5.001	6.800	8.600	10.400
Income tax revenue	14.532	15.095	14.707	-0.388	15.938	17.277	18.354			
Federal Transfers	7.979	7.988	7.918	-0.070	8.218	8.470	8.645			
Other revenue	16.685	18.081	19.722	1.641	19.894	20.685	21.848			
Total Revenue	**42.293**	**44.918**	**46.881**	**1.963**	**47.879**	**50.615**	**53.848**	**57.800**	**62.300**	**66.300**
% change	*-0.7*	*6.2*	*10.8*	*4.6*	*2.1*	*5.7*	*6.4*	*7.3*	*7.8*	*6.4*
Expense										
Operating Expense (net of program re-allocations)	44.661	45.906	46.370	0.464	47.765	49.053	50.291	52.000	53.800	55.600
% change	*3.1*	*2.8*	*3.8*	*1.0*	*3.0*	*2.7*	*2.5*	*3.4*	*3.5*	*3.3*
Debt servicing costs	1.018	1.398	1.355	-0.043	1.921	2.434	2.937			
Other	7.396	7.611	8.222	0.611	6.494	6.341	6.592			
Disaster assistance (with operating 2013 flood support)	1.191	0.235	0.495	0.260	0.206	0.200	0.200			
Capital grants (including 2013 flood support)	2.159	3.302	3.729	0.427	1.706	1.352	1.596			
Amortization / loss on disposals	2.302	2.449	2.458	0.009	2.478	2.570	2.616			
Inventory Consumption	0.908	0.926	0.904	-0.022	0.956	1.007	1.061			
Pension provisions	-0.543	-0.237	-0.332	-0.095	-0.310	-0.366	-0.365			
Climate Leadership Plan	1.379	0.936	0.968	0.032	1.458	1.578	1.484			
Total Expense	**53.077**	**54.915**	**55.947**	**1.032**	**56.181**	**57.827**	**59.818**	**62.200**	**63.700**	**65.500**
% change	*8.1*	*3.5*	*5.4*	*1.9*	*0.4*	*2.9*	*3.4*	*4.0*	*2.4*	*2.8*
Risk Adjustment	*-*	*0.5*		*-0.5*	*0.5*	*0.7*	*1.0*			
Surplus / (Deficit)	**-10.784**	**-10.497**	**-9.066**	**1.431**	**-8.802**	**-7.912**	**-6.970**	**-4.300**	**-1.400**	**0.700**
Reference:										
Heritage Fund Balance	15.352	15.644	15.629	-0.015	15.957	16.260	16.585			
Contingency Account Balance	2.299	0.000	1.661	1.661	-	-	-	-	-	-

Economic Rebound to Continue, But Cool

After the tough times experienced in 2015 and 2016, Alberta's economy bounced back sharply last year with growth now estimated at 4.5%. That would be about 2%-pts higher than expected at the time of Budget 2017, with strong increases in retail sales and manufacturing shipments combining with a rebound in oil. The updated projections expect growth to continue, albeit at a slightly cooler rate in the years ahead. The average forecast of 2.5% real GDP growth over the forecast horizon is a little higher than ours and the private sector average, albeit not markedly so.

Nominal GDP growth is projected to see a more notable easing from 2017's pace, particularly this year and next, largely due to fairly conservative oil price assumptions. The assumptions for WTI oil prices through to 2020/21 ($59, $60 and $63) are at or slightly below the current spot price. Moreover, the projections don't assume any significant narrowing in the spread between WTI and Western Canada Select (WCS). As a result, resource revenues, which were an upside surprise in the outgoing fiscal year, are expected to actually be lower in 2018/19. Assumptions for employment growth (between 1.5-2.0%) are a little higher than our projections though, and that comes through in income tax revenue.

Table 2	Key Assumptions				
Y/Y % Chg	2017	2018	2019	2020	2021
Economic Assumptions					
Real GDP	4.5	2.7	2.5	2.4	2.6
Private Sector Average	*4.3*	*2.5*	*2.1*	*2.1*	*2.0*
Nominal GDP	6.8	4.7	4.3	5.6	6.0
Employment	1.0	2.0	1.7	1.8	1.6
Unemployment Rate (%)	7.8	6.8	6.2	5.7	5.3
Primary Household Income	4.4	4.5	4.7	4.8	4.9
Housing Starts (K)	29.5	30.2	32.0	33.3	35.2
Net Corporate Operating Surplus	90.6	19.1	9.8	19.5	20.2
CPI	1.6	2.1	1.9	2.0	2.0
Population	1.2	1.4	1.5	1.5	1.6
Financial Assumptions (Fiscal Yr)	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
3-month T-Bills (%)	0.51	0.90	1.60	2.20	2.50
10-year GoC Bonds (%)	1.39	1.90	2.50	2.90	3.10
Exchange Rate (US¢/C$)	76.2	78.0	80.0	80.0	80.0
WTI (US$/bbl)	47.93	54.00	59.00	60.00	63.00
WCS @ Hardisty (C$/bbl)	44.67	50.40	46.00	48.80	50.90
Natural Gas (C$/GJ)	2.01	1.90	2.00	2.20	2.40

Deficits Starting to Narrow

The deficit for the outgoing 2017/18 fiscal year is now projected to be just under $9.1bn. That's a $1.4bn improvement over the original budget plan. Part of that is due to the $0.5bn in risk adjustment. However, higher revenues, rising 10.8% compared to the 6.2% expectation, also played a big role. Of the almost $2bn improvement in revenue projection for 2017/18, $0.78bn can be attributed to resources, with the rest coming from other factors, specifically investment income and net income from government business enterprises.

For the coming 2018/19 fiscal year, the wider spread between WTI and WCS prices contributes to a reduction in resource revenue. That's offset by increases in personal and corporate income tax revenues, as well as slightly higher transfers from the federal government. On the expense side, operating expenses are slated to rise by 3.0%, a slight deceleration from 2017/18. "Other" costs, most notably capital grants, including those for flood support, are expected to be lower in 2018/19. Meanwhile debt service costs will rise from $1.36bn to $1.92bn, before reaching $2.94bn by 2020/21. Overall, the 2018/19 deficit is projected to be only marginally slimmer than the outgoing year, at $8.8bn, although that includes a $0.5bn risk adjustment.

Long Run Road Map to Balance

Detailed budget projections were again provided for the coming three years, and show the deficit sliming to just under $7bn by 2020/21, with that year's projection including a larger $1bn risk adjustment.

For the first time, though, the Province laid out a road map for returning the budget to balance by 2023/24. In the second three year period (2021/22 – 2023/24), revenue growth is projected to average a little over 7%, compared to an average of 4.7% in the first three years of projections, with resource revenue doing a lot of the heavy lifting. Of the almost $7.7bn improvement in the budget balance coming between 2020/21 and 2023/24, $5.4bn comes from a rise in resource revenue. An adjustment for risk isn't included in the longer-term projections.

Borrowing Needs Remain Elevated

Alberta's borrowing requirements will remain elevated over the five-year forecast horizon, in spite of a projected narrowing of the deficit. This reflects large capital needs for infrastructure programs and refinancing. Alberta projects it will borrow $26.1bn in 2018/19, up approximately $2.0bn from 2017/18. This includes $10.5bn in money market debt it intends to roll over. Borrowings include $7.0bn for the Fiscal Plan and $4.3bn for Capital Purposes.

Table 3	FINANCING PLAN			
C$Millions	2017/18	2018/19	2019/20	2020/21
	Estimate*	Forecast	Forecast	Forecast
Borrowing Requirements				
Borrowing for Capital Purposes	5,434	4,272	7,582	7,336
Borrowing for Fiscal Plan	4,494	7,038	8,174	6,880
Cash Reserve	5,000	5,000	5,000	5,000
Borrowing for Orphan Wells Association	50	145	188	175
Short term borrowing for working capital	1,000	1,000	1,000	1,000
Borrowing for Corporations	-	-	-	
AFSC	200	406	463	413
ACFA	4,250	3,760	2,975	4,572
ATB	2,600	3,000	1,700	1,650
APMC	475	675	590	500
Balancing Pool	650	810	1,010	1,210
Total Borrowing for Corporations	8,175	8,651	6,738	8,345
Total	24,153	26,106	28,682	28,736
Funding Requirements				
Bonds, FRNs, & MTNs	13,500	15,400	17,600	17,500
Savings Bonds	-	-	-	-
CPP	-	-	-	-
Money Market Debt	10,653	10,706	11,082	11,236
Total	24,153	26,106	28,682	28,736
Gross LTD Maturities Alberta & Corporations	3,640	2,790	5,017	5,303
Net New LTD Issuance	9,860	12,610	12,583	6,264

**Revised estimate*

Alberta's Budget 2018 Capital Plan is $29.9bn over five years; $26.6bn for core government and $3.3bn for the self-financed SUCH sector.* The capital plan has been scaled back with reduced need for economic stimulus and to factor in competition for resources with the private sector. Projects cover health care, including the new Edmonton Hospital and Calgary Cancer Centre, municipal grants, climate change and environmental sustainability, education, transit and transportation infrastructure.

The Capital Plan entails $29.9bn in total financing over five years of which $20.5bn (approximately 69%) will be funded through Direct Borrowing. The balance of funding will come from a combination of Alternative Financing – P3s ($0.9bn), Other Cash Sources ($2.9bn), Climate Leadership Plan ($2.4bn) and SUCH Sector Self-Financing ($3.3bn).

In Alberta's 2017/18 mid-year update, it trimmed its financing requirements to $14.9bln, from $16.1bln in the Q1 update and from $18.7bln in Budget 2017. The reduction reflected a $1.4bn reduction in the deficit from Budget 2017 due mostly from higher revenue and the removal of the $0.5bn risk adjustment. It also reflected the re-profiling and deferral of projects in later years and additional cash from 2016/17 results.

Alberta's increasing debt requirements have been funded through an expanded and diversified borrowing platform. This platform covers:

- Domestic (short-term) Promissory Note
- Domestic Platform for benchmark and MTN issuance
- Australian Medium Term Note programme
- Global Bonds (SEC Registered)
- Global Medium Term Note – (Rule 144A inside the U.S. and Regulation S)
- US Commercial Paper program

Alberta's borrowing strategy is focused on:

- Maintaining larger domestic benchmark issues ($3-5bn)
- Occasional domestic MTN issuance
- Targeting 30-40% of total term debt issuance in foreign currencies, specifically:
    - Liquid US$ global issues in 3, 5, 7 and 10 years

- SEC registered, large US$ benchmarks
- Sterling benchmarks
- Euro benchmark issues
- MTN and structured issues in other currencies

Alberta has approximately $57bn of outstanding marketable debt which includes guaranteed subsidiaries. It also has money market debt outstanding of approximately $10bn, which it expects to remain in place during the fiscal year.

The Province is currently rated: DBRS AA negative, Moody's Aa1 negative, S&P A+ stable. In our opinion, today's budget will do little to sway DBRS and Moody's to revise their negative outlooks to stable. The possibility remains of them implementing a downgrade, given the long path to balance, optimistic revenue growth projections and still generous expense growth projections beyond 2018/19.

However, given the multiple credit rating downgrades to date, which place some of the Province's ratings at a level with more headroom, additional downgrades may materialize slowly. Additional positive offsetting credit considerations include a stronger economy, gradual projected increase in the debt burden from a very low base, and above-average fiscal capacity. An election in spring 2019 may also keep the rating agencies on the sidelines.

We highlight that the road to balance is long (2023/24) and much depends on the economy unfolding as expected. There were no fiscal measures introduced to signal a shift in stance toward a more swift return to balance. Budgetary projections do incorporate a buffer of $500mn against the risk of weaker than anticipated energy royalties. This seems reasonable against a more conservative forecast which shows bitumen royalties falling to $1.8bn in 2018/19 from $2.4bn in 2017/18. It steps up to $700mn and $1bn, respectively, in 2019/20 and 2020/21. However, this buffer is significantly reduced with the projected elimination of the once multi-billion dollar Contingency Account at the end of the upcoming fiscal year. The Contingency Account Balance was around $6.5bn in 2014/15, at the beginning of the oil price downturn. We note, however, that the depletion of this account is a year later than projected in last year's budget, with the stronger than expected economic growth and oil prices.

Notwithstanding the built-in suspenders, there are significant risks to the forecast, which include the potential for a change in trade relations with the United States (i.e. border taxes, quotas), increasing US oil production which is expected to limit oil price advancements, and transportation constraints (i.e. pipeline, rail) that are reducing net backs as Western Canada Select remains heavily discounted to WTI.

Alberta's liquidity is exceptional with its diversified funding platform and substantial holdings of unencumbered and available financial assets. The cornerstone of its stalwart liquidity is the Heritage Fund. This Fund had an estimated fair value of $17.5bn at December 31, 2017. The province has stated that it will not draw on the Heritage Fund. This Fund is an internally designated asset under legislation to provide stewardship of savings from Alberta's non-renewable resources revenues. Nonetheless, Alberta's financial assets provide substantial coverage of its annual debt service requirements and are expected to remain a multiple above 100% of its annual debt service — the threshold upholding the province's very high liquidity score by the rating agencies.

With significant, yet diminishing deficits, combined with new financing requirements for capital projects, Alberta's debt metrics are projected to still worsen over the forecast period. The province projects that its Debt-to-Nominal GDP Ratio will increase from 6.0% in F2017/18 to 12.4% by F2020/21. With substantial debt maturities over the next 10 years, rising interest rates could potentially have a negative impact on this projection. We estimate that the coupon on Alberta's maturing debt in the next four years is about a half a percentage point below the current yield on its 10-year bonds, which will be a drag if it chooses to refinance in that tenure or longer.

In the next five years, the Province has over $22bn in debt maturing, representing about 39% of its outstanding marketable debt (Source: Bloomberg).

Although some rating agencies consider Alberta's debt burden high on a debt-to-GDP and debt-to-revenue basis for the given ratings, we highlight that, even at higher projected levels of debt, Alberta still has one of the lowest debt burdens among the Canadian provinces (on an adjusted basis by DBRS). Alberta's fiscal capacity is also the strongest, as it chooses to retain its significant tax advantage that is noted for the absence of provincial sales tax and a very competitive income tax structure for individuals, small businesses, and corporations.

This is further described in our Special Report: Understanding Canada's Federal – Provincial Fiscal Arrangements (March 20, 2018)

*Schools, Universities, Colleges, Hospitals (SUCH) Sector