August 27, 2020

Alberta offers “incredibly sobering” update as virus/low oil weigh

By Warren Lovely

- **Revised 2020-21 fiscal picture:** Finance Minister Toews presented an “incredibly sobering” (his words) fiscal update today. The budget balance has morphed from a planned deficit of $7.3 billion to a revised shortfall of $24.2 billion, stung by the one-two punch of COVID-19 and low oil prices. So Alberta’s deficit has shot up by $16.8 billion relative to February’s plan, and in Toews’ own words, leaving this gap unchecked would create a “grim reality for Albertans”. As an in-year/quarterly update, the revised fiscal picture relates only to 2020-21. Looking backwards, however, Alberta’s *Annual Financial Report* (released alongside the quarterly) confirmed a $12.2 billion deficit for 2019-20, as revenue fell below plan (although nothing like what we’re seeing this fiscal year).
- **Revenue profile:** Attribution analysis traces the lion’s share (about 70%) of the larger deficit to a weaker revenue picture. To be specific, top-line revenue is down $11.5 billion or a hefty 23% vs. budget.
  - That includes a substantial mark-down in non-renewable resource revenue, off $3.9 billion to just $1.2 billion. That’s a level not seen since the 1970s. Looked at another way, this resource-centric province now expects to directly derive barely 3% of full-year revenue from non-renewable resources, highlighting the difficulties faced by the oil and gas sector. As per the update: “Many oilsands projects are generating minimum or no positive returns this year, reducing significantly any royalty payable under the revenue minus cost royalty regime.” WTI is now expected to average US$35.6/bbl, the forecast being cut more than $22 vs. the earlier budget assumption, and only partially offset by a tighter-than-expected differential and cheaper CAD. (For reference, the prompt contract on WTI is today trading at US$43/bbl, having averaged US$33/bbl since the start of the fiscal year—which included a couple notable days in extreme negative territory back in April.)
  - Echoing a theme seen almost everywhere, income tax revenue has been severely crimped by widespread economic dislocation since the virus took hold. Ditto for other revenue streams, which have generally been knocked back vs. plan. There may be no sales tax in Alberta—and no plans to implement one—but lower consumption has weighed on revenue from fuel taxes, tobacco/tourism levies, etc. Gaming revenue is down sharply, as casinos were temporarily shuttered. Loan loss provisions have negatively impacted net income at ATB Financial. Among other pressures, investment income looks to be off >40% vs. budget, as losses are realized and a smaller asset base limits scope for income growth.
  - Of note, federal transfer revenue has been enriched by ~$850 million relative to budget, reflecting part of Ottawa’s large-scale fiscal stimulus effort. Total federal transfer support, at a snick under $10 billion, should account for fully one quarter of Alberta’s revenue this fiscal year. Extra monies here can be traced to a Site Rehabilitation Program for the oil and gas industry (which will help address orphan wells), along with Alberta’s share of the Safe Restart Agreement (struck with the provinces in July), on top of additional revenue from a low carbon funding envelop. Notwithstanding the extra federal support, Alberta continues to press for “fair treatment” from Ottawa, including removal of a $60/per resident cap on fiscal stabilization payments. For 2020-21 alone, removal of this cap could be worth some $4 billion to Alberta, to say nothing of an estimated $2.4 billion in cumulative foregone stabilization payments tied to an earlier bout of oil price weakness (2015-16 to 2016-17).
- **Expenditure profile:** Spending has been revised $5.3 billion or more than 9% above budget, capturing public health outlays and related relief/stimulus measures tied to the virus. If you’re willing to strip out COVID-related items, contingencies and other special or one-time provisions, the underlying spending profile isn’t far removed from budget. In addition to extra health outlays, the purchase of PPE and various stimulus efforts, capital grants to municipalities were enriched. Alberta set aside $1.25 billion to further unwind crude-by-rail contracts, not all of which were dealt with in the prior year. (The related provision in 2019-20 ended up at $866 million.) Separately, there’s $259 million of an original $750 million contingency still unallocated for 2020-21.
- **Debt burden:** A decisively larger deficit and enlarged capital plan mean extra debt. Alberta’s total taxpayer-supported debt is now within a hair’s breadth of $100 billion, jumping $25.4 billion year-on-year. Not to confuse the matter, but an alternative debt measure—net financial liabilities, which gives credit for the value of financial assets (including at the Heritage Fund)—is expected to end up at $66.9 billion or 22.4% of GDP. Alberta’s net debt ratio is still below most other provinces but has been growing rapidly, thrown into overdrive in 2020-21 by the pandemic and weaker oil prices. The heavier debt load has not been lost on credit rating agencies, three of which (S&P, Morningstar DBRS and Fitch) had assigned a “negative” trend prior to today’s release. For reference, Alberta’s actual net debt burden was 11.6% in 2019-20. To be fair, a portion of this year’s jump in the debt ratio captures extreme but temporary weakness in nominal GDP, which is a common denominator in debt burden calcs. As observed in other quarters, the larger budgetary shortfall and added debt hasn’t really produced much in the way of incremental interest charges, thanks to an extremely low interest rate environment.
- **Borrowing requirement:** As might be expected with a fiscal revision as large as this, there’s now officially more borrowing to be done. To be precise, the Q1 Update puts the 2020-21 long-term gross borrowing requirement at $29.9 billion. That includes direct borrowing for the fiscal and capital plans, and is likewise inclusive of funding for provincial corporations/GBEs. Compared to Budget 2020, the gross bond requirement has increased by $12.8 billion, but that didn’t necessarily catch bond investors off guard, judging from the relatively contained reaction in Alberta’s domestic credit spreads. Importantly, the province has been proactive in accessing debt capital markets since the fiscal year kicked off back on April 1st. Based on our calculations, Alberta has already

secured ~$19 billion in term funding, leaving the funding program running ahead of schedule even against the new, larger requirement. Given extremely attractive all-in funding costs, and what has been solid investor demand of late, we'd expect Alberta to remain firmly engaged issuance wise. That would presumably include the ongoing build-up of large, liquid benchmarks in the domestic market, supplemented (subject to favourable market conditions) by international offerings. To us, USD funding opportunities appear reasonably compelling, notwithstanding a slight wobble in high grade spreads in recent sessions. Credit Alberta for an active IR effort in recent years, designed to broaden the investor base to the widest extent possible and helpful when faced with an extraordinary funding requirement.

- **Long-term credit ratings (latest rating report/action date in parentheses):**

  S&P: A+, Negative (28-May-20) | Moody's: Aa2, Stable (28-Apr-20) | DBRS: AA(low), Negative (19-Mar-20) | Fitch: AA-, Negative (30-Jun-20)

- **Economic outlook:** The updated economic outlook puts the virus/oil hit into greater perspective. Real GDP is seen contracting by 8.8% in 2020, with nominal output shrinking 13.9%. Needless to say, the revised forecasts contrast mightily with the moderate positive growth originally penciled in. The province notes that some 170K jobs have been lost, pushing the unemployment rate to nearly 13%. Other elements of the economic narrative will be familiar to many: the normally resilient services side of the economy has been hard-hit by the pandemic; weaker global demand has hurt export performance; investment has pulled back (including of course in the energy sector); consumers have retrenched; population growth has slowed as immigration levels fall. In Alberta, as elsewhere, acute economic weakness has forced government to step into the breach with exceptional stimulus measures. The province's Job Creation Tax Cut—a key policy thrust, but hardly the sole initiative to counter the virus—aims to speed a recovery in jobs and investment. The Q1 Update cites more recent rebounds in some hard-hit sectors, with improving labour and housing markets also encouraging, even if uncertainty remains elevated. Tentative forecasts for 2021 would see real GDP advancing by 4.6% and nominal output up 6.3%, a pace of expansion that would leave the average unemployment rate at 9.5%.

Conclusion

It was fully assumed that this quarterly update would usher in a major fiscal revision, and that's exactly what we got. Using some not-so-subtle language, Alberta's finance minister laid bare the hit to the province's economy and public finances from the COVID-19 pandemic and low oil prices. The deficit has jumped to around 8% of GDP, and the degree of revenue weakness is striking—significant revenue volatility having long been observed here. While today's update does not provide future year guidance, the minister stressed the importance of getting not just the economy but the budget back on a more sustainable footing. After all, Alberta's rapid buildup of debt has resulted in a series of rating downgrades, with some credit rating agencies continuing to flag downside credit risks (in the form of "negative" outlooks). As in other jurisdictions, details of a multi-year fiscal recovery plan will need to be spelled out this fall. Notwithstanding a significant tax advantage vs. other provinces, the emphasis seems likely to be on spending restraint. Stay tuned. It's worth noting some encouraging economic results of late. Where the proverbial rubber hits the road for bond investors—in other words, the borrowing program—extra requirements were largely taken in stride, credit spreads holding in/around pre-release levels. All told, Alberta needs to issue about $30 billion of term debt this fiscal year. But the province got a nice jump start on its financing program and, like a few other provincial borrowers, could turn to international markets to help advance its funding program… complementing the ongoing establishment of regular liquid domestic benchmarks.

Fiscal Plan Summary
(millions of dollars)

Income Statement

	Fiscal Year			Change from Budget
	2019-20 Actual	2020-21 Budget[a]	2020-21 Forecast	
Revenue				
Income tax revenue	15,351	17,105	**12,858**	(4,247)
Other tax revenue	5,747	5,782	**5,242**	(540)
Non-renewable resource revenue	5,937	5,090	**1,224**	(3,866)
Other revenue	19,189	22,019	**19,125**	(2,894)
Total Revenue	**46,224**	**49,996**	**38,449**	**(11,547)**
Expense				
Operating expense	48,616	47,809	**47,896**	87
Capital grants	1,696	2,302	**2,380**	78
Amortization / inventory consumption / loss on disposals	3,720	3,857	**3,904**	47
Taxpayer-supported debt servicing costs	1,783	2,066	**2,220**	154
Self-supported debt servicing costs	452	439	**306**	(133)
Pension provisions	(334)	(415)	**(389)**	26
Expense (excl. COVID-19 / Recov. Plan, contingency, crude-by-rail)	55,936	56,056	**56,317**	261
COVID-19 / Recovery Plan:				
Operating expense	218	500	**3,021**	2,521
Capital grants (municipal)	-	-	**638**	638
Inventory consumption (PPE)	-	-	**632**	632
Disaster and emergency assistance - allocated	1,356	-	**491**	491
Contingency / disaster and emergency assistance - unallocated	-	750	**259**	(491)
Crude-by-rail provision	866	-	**1,250**	1,250
Total Expense	**58,376**	**57,306**	**62,608**	**5,302**
Surplus / (Deficit)	**(12,152)**	**(7,310)**	**(24,159)**	**(16,849)**

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
Associate, Rates Strategist, Economics and Strategy
taylor.Schleich@nbc.ca

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