March 22, 2018

# Economic diversification & long-term deficit reduction in focus

## Highlights

- After a couple of very tough years, Alberta's economy regained important traction in 2017, as real GDP shot 4.5% higher. That led all the provinces and was considerably better than originally projected.
- A more forceful economic recovery allowed for better-than-expected fiscal results. Alberta estimates it ran a $9.1 billion deficit in the 2017-18 fiscal year, down from the peak deficit level of $10.8 billion established in 2016-17 and a $1.4 billion improvement vs the original budget plan for 2017-18.
- Real GDP is expected to climb 2.7% this year, moving "closer to a full recovery", followed by roughly 2½% average annual gains thereafter. Nominal growth is pegged at 4.7% in 2018, ranging from 4.3% to 6% in the subsequent three years.
- "Returning to balance" is one the budget's three central pillars, along with diversifying the economy and protecting vital public services. The budget is notable for its additional transparency and detail around the longer-term deficit reduction plan, spelling out for the first time the precise assumptions that underpin a return to balance by 2023-24.
- The budget puts the 2018-19 deficit at $8.8 billion, equivalent to ~18% of total revenue or 2.5% of GDP (at the high end of the provincial spectrum). The medium-term fiscal plan would see the deficit falling to $7.9 billion in 2019-20 and then to $7.0 billion by 2020-21. Progress on the deficit accelerates from there, culminating in a $0.7 billion surplus come 2023-24. Almost 70% of the cumulative, six-year fiscal improvement arrives in the final three years of the deficit elimination plan.
- There's an explicit "risk adjustment" of $500 million for 2018-19, growing to $700 million in 2019-20 and hitting $1 billion in 2020-21. The longer-term fiscal targets do not incorporate a risk adjustment.
- Despite a stronger and more diversified economy, getting back to balance will also require cost containment. Operating spending growth will need to be held to an average annual rate of 3.1% until the books are balanced, below the combined rate of headline inflation and population growth each and every year through 2023-24. The federal portion of a carbon levy would be used to support public services.
- WTI is projected to average US$59/bbl in the coming fiscal year (vs current spot of $64.20). The all-important light-heavy differential is pegged at US$22.40/bbl for 2018-19 (vs current level of $23.50). Economic and fiscal assumptions incorporate key pipeline expansions, specifically the Line 3 replacement and the Trans Mountain Expansion. Alberta is nonetheless moving to bolster value-added activity in-province, earmarking fully $2 billion in grants/loan guarantees/royalty credits to leverage energy sector investment.
- With cumulative deficits of $21.5 billion (before the risk adjustment) slated for the coming three years, Alberta's net debt will continue to accumulate (from a relatively low base). The net debt-to-GDP ratio, which is due to end 2017-18 at 6.0% would rise to 8.7% in the coming year, reaching 12.4% by 2020-21. There's a stated commitment to maintain one of the lowest net debt ratios in Canada.
- The Heritage Fund is valued at $15.6 billion as at the end of 2017-18, with inflation proofing set to bring it up to $16.6 billion by March 2021.
- A $5 billion "cash reserve" provides a buffer should market access deteriorate unexpectedly and is a prudent approach for an issuer with non-trivial borrowing requirements.
- Alberta expects to tap debt capital markets for $15.4 billion in term funding in 2018-19. Long-term funding needs are ~$17½ billion in the two subsequent fiscal years. The borrowing strategy would see 30-40% of term funding sourced from international markets. The domestic (C$) program focuses on maintaining large, liquid benchmark bonds, with MTN issuance likely to be "infrequent".

## Important recovery secured in 2017

After a couple of very tough years, Alberta's economy regained important traction in 2017, as real GDP shot 4.5% higher. That led all the provinces and was considerably better than originally projected—last year's budget had assumed 2.6% growth. Given firmer energy prices, nominal growth was a brisk 6.8% last year.

This more forceful economic recovery allowed for better-than-expected fiscal results. Consistent with the previously released Q3 update, Alberta now estimates it ran a $9.1 billion deficit in the 2017-18 fiscal year (which concludes in just a few days from now). That's down from the peak deficit level of $10.8 billion established in 2016-17 and also marks a $1.4 billion improvement vs the original budget plan for 2017-18. While part of the in-year success ($500 million) reflects the release of an unneeded "risk adjustment", it's clear from the detailed fiscal tables that revenue ended up on a much sturdier footing than originally foreseen.

Indeed, there was nearly $2 billion (+4.4%) of incremental revenue in 2017-18 vs plan. Specifically, there was some $780 million in extra resource revenue (mainly via conventional oil and natural gas royalties, and bonus land sales), a major (almost +$1 billion) assist from buoyant investment income at the Province's endowment funds (notably the Heritage Fund), alongside stronger net income from government business enterprises (reflecting recoveries in the "Balancing Pool", which manages the cost tied to the return of power purchase agreements).

This revenue windfall meant that even with extra spending—program expense was $1.17 billion or more than 2% above plan—some welcome progress on the deficit was recorded.

## Sustained economic expansion…

Where does Alberta go from here? Well, the Province sees itself moving from economic recovery to a more sustained (and diversified) expansion. Real GDP is expected to climb 2.7% this year, moving "closer to a full recovery", followed by roughly 2½% average annual gains thereafter. Nominal growth is pegged at 4.7% in 2018, ranging from 4.3% to 6% in the subsequent three years.

It's always worth lining up budget planning assumptions with the private sector consensus. On that score, the government has built in above-consensus real GDP gains each year from 2018 to 2021, but has assumed slower nominal growth this year and next vis-à-vis private sector forecasters.

What's driving growth? For starters, demographics are favourable; Alberta is a relatively young province, which continues to enjoy healthy population growth. Some segments of non-residential investment, manufacturing output and exports look quite bright (specifically in refining and petrochemicals). Of note, the new Sturgeon Refinery produced its first diesel at the end of last year.

The investment outlook in the oil sands may still be cloudy, but earlier investments continue to pay dividends in the form of rapidly expanding bitumen production. To wit, raw bitumen production jumped 12% in 2017-18 and is expected to expand at another double-digit clip (11% or >300K/bpd) this coming fiscal year. Further gains are eyed in each of two following years, leaving raw bitumen output at nearly 3.5 million barrels a day come 2020-21.

## … key part of fiscal recovery path

Given the improving economic backdrop, it would be reasonable to expect further progress on the deficit. Thus, "returning to balance" is one the budget's three central pillars, along with diversifying the economy and protecting vital public services.

The budget is notable for its additional transparency and detail around the longer-term deficit reduction plan, spelling out for the first time the precise assumptions that underpin a return to balance by 2023-24. Even if one must always treat long-term economic and fiscal forecasts with a degree of caution, it's nice to see the deficit elimination strategy taking shape and we certainly welcome this addition to Alberta's budget documents.

First things first: the budget puts the 2018-19 deficit at $8.8 billion, equivalent to ~18% of total revenue or 2.5% of GDP (placing Alberta's relative budget shortfall at the high end of the provincial spectrum). Total revenues are expected to grow 2.1%, which might not sound that sturdy until you factor in the stellar, 10.9% surge in the prior fiscal year. Personal and corporate income taxes are expected to lead in 2018-19. Operating expenses are projected to grow a bit more than 3%, falling in real per capita terms.

The medium-term fiscal plan would see the deficit falling to $7.9 billion in 2019-20 and then to $7.0 billion by 2020-21. After that, progress on the deficit is meant to accelerate, culminating in a $0.7 billion surplus come 2023-24.

Looking at the full six years of Alberta's remaining deficit reduction path, you might reasonably identify two sub-eras last three years apiece: 2018-19 to 2020-21, when revenue growth is somewhat slower and deficit reductions are more gradual; and 2021-22 to 2023-24, when revenue growth picks up (particularly resource revenue), allowing the budgetary red ink to be erased more quickly. Break down the numbers and you'll find that almost 70% of the $9.8 billion cumulative, six-year fiscal improvement arrives in the final three years of the plan.

What really underpins this deficit reduction plan? Well, there's that positive growth story we outlined up front (solid, sustained real GDP growth, annual population gains in the neighbourhood of 1½%, more jobs, falling unemployment, contributions from a more diverse set of sectors, etc). And to be clear, the economic and fiscal assumptions incorporate key pipeline expansions, specifically the Line 3 replacement and the Trans Mountain Expansion (TMX). Although unbuilt and facing opposition in certain corners, these projects are thought to alleviate pipeline bottlenecks in 2020-2021.

Despite a stronger and more diversified economy, getting back to balance will also require cost containment. As the Province concedes: "the budget will not balance itself." So, there will be a focus on "practical" agreements with labour unions, where job security will be offered up in exchange for wage freezes. Non-unionized government workers can expect their salaries to remain frozen, while certain high-paid executives (including in the broader public sector) will see salaries, bonuses and perks cut. Some government agencies, boards and commissions will be dissolved or amalgamated.

Overall, operating spending growth will need to be held to an average annual rate of 3.1% until the books are balanced, well shy of historical gains and below the combined rate of headline inflation and population growth each and every year through 2023-24. Savings/efficiencies will continue to be sought (e.g., drug costs, corporate services, travel/hospitality), while the capital plan will revert to more "normal" levels, consistent with a recommendation from former-BoC Governor David Dodge. The idea here is that as the economy recovers, extraordinary (and highly simulative) capital spending becomes less necessary. We tend to agree with Mr. Dodge on this. Funding arrangements for municipal governments, put in place when oil prices were quite high, will also be reworked.

## Energy assumptions, sensitivities, risk adjustment and fiscal room

As for the commodity price assumptions, here are the essential numbers (taken directly from the budget):

**Energy and Economic Assumptions**

| | Forecast | Estimate | Target | |
|---|---|---|---|---|
| | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
| WTI Oil (US$/bbl)[7] | 54.00 | 59.00 | 60.00 | 63.00 |
| Light-Heavy Differential (US$/bbl)[7] | 14.50 | 22.40 | 21.00 | 22.30 |
| WCS@Hardisty (Cdn$/bbl)[7] | 50.40 | 46.00 | 48.80 | 50.90 |
| Natural Gas (Cdn$/GJ)[7] | 1.90 | 2.00 | 2.20 | 2.40 |
| Conventional Crude Oil Production (000s barrels/day) | 449 | 461 | 468 | 466 |
| Raw Bitumen Production (000s barrels/day) | 2,855 | 3,163 | 3,302 | 3,462 |
| Interest Rate (10-year Canada bonds, %) | 1.90 | 2.50 | 2.90 | 3.10 |
| Exchange Rate (US¢/Cdn$)[7] | 78.0 | 80.0 | 80.0 | 80.0 |

As you can see from the above table, WTI is projected to average US$59/bbl in the coming fiscal year (vs current spot of $64.20). The all-important light-heavy differential is pegged at US$22.40/bbl for 2018-19 (vs current level of $23.50). Detailed "benchmarking tables" (conducted on a calendar year basis) reveal that the government has assumed a larger differential than the average private sector forecast for each year from 2018 to 2021. (That gap vs consensus averages more than US$4/bbl over that four-year period.) Note that new rules related to the sulphur content of marine fuels are thought to reduce demand for bunker fuel (sourced from heavy oil). You don't have to be a commodity strategist to appreciate that the realized light-heavy differential will also, in part, be a function of whether the aforementioned pipelines get put in place. After all, as the budget plainly states: "there is limited pipeline capacity to the two largest heavy oil markets in the world, the US Gulf Coast and Asia". From Alberta's perspective, TMX is absolutely critical.

Not content to stand still, Alberta is moving to bolster value-added activity in-province. Fully $2 billion has been earmarked in grants/loan guarantees/royalty credits to leverage investment in the energy sector, be it new upgrading facilities, petrochemical manufacturing plants or for petrochemical feedstock infrastructure.

Official sensitivities provide a gauge (admittedly an imperfect/nuanced one) as to how much fiscal pressure could emerge should energy prices fail to cooperate… or more positively, how much brighter things could get should oil prices top assumptions and/or the differential narrow in more than expected:

**Fiscal Sensitivities to Key Assumptions in Budget, 2018-19**

| (millions of dollars) | Change | Net Impact (2018 – 2019) |
|---|---|---|
| Oil Price (WTI US$/bbl) | -$1.00 | -265 |
| Light-Heavy Differential (US$/bbl) | +$1.00 | -210 |
| Natural Gas Price (Cdn$/GJ) | -10 Cents | +10[9] |
| Exchange Rate (US¢/Cdn$) | +1 cent | -198 |
| Interest Rates | +1% | -226 |
| Primary Household Income | -1 % | -150 |

Clearly, even modest moves in the differential can have material bearing on Alberta's revenue outlook. Note, however, that the Province has prudently built some padding into the fiscal plan. There's an explicit "risk adjustment" set at $500 million in 2018-19, growing to $700 million in 2019-20 and hitting an even one billion dollars in 2020-21. The longer-term fiscal targets (i.e., for 2021-22 and beyond) do not incorporate a risk adjustment.

A final word on longer-term energy assumptions and the contribution to deficit reduction. Based on further projected gains in WTI (US$73/bbl by 2023-24), a progressively smaller differential (US$18.4/bbl by 2023-24) and higher production levels, resource royalties are projected to top $10 billion by 2023-24, comprising almost 16% of total revenue or about double the share anticipated in 2018-19. So notwithstanding the focus on diversifying the economy and reducing the Province's reliance on resource revenue, that very revenue source appears quite important to the government's deficit reduction plan. Fact is, over the coming six years, resource royalties are expected to outgrow the remaining revenue pie by margin of more than 3:1. The government has also indicated that the federal portion of a carbon levy would be used to support public services.

When it comes to the so-called "tax advantage", Alberta estimates its 2018-19 edge at no less than $11 billion vs its nearest provincial competitor (British Columbia). In other words, were Alberta to match the tax framework (including carbon pricing) of its Western neighbour, individuals and businesses would be remitting an extra $11 billion to Edmonton (all else equal). Alberta's tax edge vs Ontario is projected at some $14 billion/year. As with BC, the majority of that advantage reflects the fact that Alberta remains the only province without a sales tax.

A quick aside on cannabis legalization (and related revenue): the Province estimates it will bring in $80 million/year by 2019-20, pursuant to a federal-provincial revenue sharing agreement. Other tax items of note include a new digital media tax credit and extended investor tax credits, all of which are designed to aid diversification, spur innovation and foster a vibrant tech sector. In the same vein, the government is investing in 3,000 new post-secondary technology spaces and enhancing technology scholarships. A tuition freeze has been extended for a fourth year. As at the federal level, Alberta is moving to implement "gender budgeting", including gender analysis in planning/reporting/programming.

## Balance sheet dissection and a look at borrowing needs

In recent years, outsized deficits have meant the Province's net financial position has eroded rapidly, admittedly from a *very strong* starting point. Recall that Alberta had a nifty net financial asset position prior to the collapse in energy prices. But as 2017-18 draws to a close, net debt tops $20 billion—still quite low by provincial standards but a sharp enough deterioration to have triggered earlier credit rating actions.

With cumulative deficits of $21.5 billion (before the risk adjustment) slated for the coming three years, Alberta's net debt will continue to accumulate (again, from a relatively low base).

The Province expects to add just over $10 billion to net debt in 2018-19, bringing the level to $30.5 billion. Net financial debt is seen topping $48 billion by 2020-21. The associated net debt-to-GDP ratio, which is due to end 2017-18 at 6.0% would rise to 8.7% in the coming year, reaching 12.4% by 2020-21. The government has stated its commitment to maintain one of the lowest net debt ratios in Canada and it should be noted that the projected peak level (13.1% in 2021-22) would be lower than the *current* debt ratio in every other provincial jurisdiction.

Part of what holds down Alberta's net debt burden is a collection of financial assets, including endowment funds (of which the Heritage Savings Trust Fund is the most material). The Heritage Fund is valued at $15.6 billion as at the end of 2017-18, with inflation proofing set to bring it up to $16.6 billion by March 2021.

You'll find a new balance sheet item in the form of a $5 billion "cash reserve", which was built up in the outgoing fiscal year (financed via incremental short-term borrowing). Consider this a prudential liquidity facility, similar to what some other provinces have put in place. It's a buffer should market access deteriorate unexpectedly and is a prudent approach for an issuer with non-trivial borrowing requirements.

The Province's aggregate gross funding need ($26.1 billion in 2018-19) incorporates borrowing for the capital plan, for the fiscal plan (i.e., related to the deficit), net Crown requirements, as well as the roll-over of debt (including some $10 billion in short-term paper).

Alberta expects to tap debt capital markets for $15.4 billion in term funding in 2018-19. Long-term funding needs are ~$17½ billion in the two subsequent fiscal years. The stated borrowing strategy would see 30-40% of term funding sourced from international markets, including via large US$ global issues (SEC registered) in 3s through 10s, alongside other foreign currency trades should market conditions prove favourable (e.g., GBP, EUR). The domestic (C$) program focuses on maintenance of large, liquid benchmark bonds (in the area of $3-5 billion in outstandings). The current maturity profile would appear to accommodate significant new issuance in key benchmark tenors. This public benchmark focus means MTN issuance is likely to be "infrequent".

Warren Lovely

# Alberta • 2018 Budget

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

***Alberta***
(millions of dollars)
CONSOLIDATED FINANCIAL STATEMENT BASIS

| | Actual 2016-17 | Budget 2017-18 | Forecast 2017-18 | Budget 2018-19 | Target 2019-20 | Target 2020-21 |
|---|---|---|---|---|---|---|
| **Revenue** | **42,293** | **44,918** | **46,881** | **47,879** | **50,615** | **53,848** |
| Personal income tax | 10,763 | 11,177 | 10,855 | 11,387 | 11,984 | 12,635 |
| Corporate income tax | 3,769 | 3,918 | 3,852 | 4,551 | 5,293 | 5,719 |
| Other taxes | 5,649 | 6,667 | 6,504 | 6,961 | 7,271 | 7,641 |
| Resource revenue - Bitumen royalties | 1,483 | 2,546 | 2,358 | 1,785 | 2,184 | 2,926 |
| Resource revenue - other | | 1,208 | 2,176 | 2,044 | 1,999 | 2,075 |
| Transfers from the Government of Canada | 7,979 | 7,988 | 7,918 | 8,218 | 8,470 | 8,645 |
| Investment income | 3,698 | 2,193 | 3,061 | 2,884 | 3,161 | 3,357 |
| Net Income from Government Business Enterprises | 543 | 2,506 | 3,294 | 2,777 | 2,707 | 2,844 |
| Premiums, Fees and Licences | 3,701 | 3,683 | 3,742 | 3,854 | 3,929 | 3,996 |
| Other | 3,094 | 3,032 | 3,121 | 3,419 | 3,617 | 4,010 |
| | | | | | | |
| **Expense** | **53,077** | **54,915** | **55,947** | **56,181** | **57,827** | **59,818** |
| Operating expense incl. re-allocation and in-year savings | 44,661 | 45,906 | 46,370 | 47,765 | 49,053 | 50,291 |
| Climate Leadership Plan operating expense | 1,379 | 868 | 577 | 1,035 | 1,132 | 1,198 |
| Climate Leadership Plan capital grants | 2 | 68 | 391 | 423 | 446 | 286 |
| Capital grants to local authorities and others | 2,159 | 3,302 | 3,729 | 1,706 | 1,352 | 1,596 |
| Disaster / emergency assistance | 1,191 | 235 | 495 | 206 | 200 | 200 |
| Amortization / inventory cionsumption / loss on disposals | 3,210 | 3,375 | 3,362 | 3,434 | 3,577 | 3,677 |
| Debt servicing costs | 1,018 | 1,398 | 1,355 | 1,921 | 2,434 | 2,937 |
| Pension provisions | (543) | (237) | (332) | (310) | (366) | (365) |
| | | | | | | |
| Risk adjustment | - | (500) | - | (500) | (700) | (1,000) |
| **Surplus (Deficit)** | **(10,784)** | **(10,497)** | **(9,066)** | **(8,802)** | **(7,912)** | **(6,970)** |
| | | | | | | |
| Contingency account - balance at beginning of year | 3,625 | 2,299 | 2,299 | 1,661 | - | - |
| Surplus (deficit) | (10,784) | (10,497) | (9,066) | (8,802) | (7,912) | (6,970) |
| Pension provisions | (543) | (237) | (332) | (310) | (366) | (365) |
| Direct borrowing for Capital plan | 4,686 | 5,954 | 5,434 | 3,772 | 3,687 | 4,265 |
| Capital investment | (3,714) | (4,786) | (4,138) | (3,455) | (3,370) | (3,486) |
| Amortization and other cash adjustments | 444 | 772 | 2,970 | 96 | (214) | (325) |
| Direct borrowing for the Fiscal plan | 8,585 | 6,495 | 4,494 | 7,038 | 8,175 | 6,881 |
| **Contingency account - balance at end of year** | **2,299** | **-** | **1,661** | **-** | **-** | **-** |
| | | | | | | |
| **Capital plan** | **6,578** | **9,175** | **9,165** | **6,444** | **5,884** | **6,032** |
| Capital grants | 2,159 | 3,302 | 3,729 | 1,706 | 1,352 | 1,596 |
| Climate Leadership Plan | 2 | 68 | 391 | 423 | 446 | 286 |
| Capital investments | 4,417 | 5,805 | 5,045 | 4,315 | 4,087 | 4,149 |
| | | | | | | |
| Contingency account | 2,299 | - | 1,661 | - | - | - |
| Other financial assets | 63,988 | 62,607 | 67,914 | 70,563 | 72,938 | 75,738 |
| Pension liabilities | 10,023 | 9,981 | 9,691 | 9,381 | 9,015 | 8,650 |
| Direct borrowing for capital projects | 21,006 | 26,984 | 26,457 | 30,246 | 33,951 | 38,233 |
| Liabilities of self-supporting lending organizations | 18,385 | 18,968 | 18,446 | 19,236 | 19,967 | 20,300 |
| Other liabilities | 25,774 | 29,789 | 35,250 | 42,210 | 49,781 | 56,714 |
| **Net financial assets** | **(8,901)** | **(23,115)** | **(20,269)** | **(30,510)** | **(39,776)** | **(48,159)** |
| Non financial assets (net of amortization) | 46,622 | 50,507 | 48,924 | 50,363 | 51,717 | 53,130 |
| **Net assets** (variation equals surplus (deficit)) | **37,721** | **27,392** | **28,655** | **19,853** | **11,941** | **4,971** |
| | | | | | | |
| **Financing requirements** | | | **24,153** | **26,107** | **28,682** | **28,736** |
| Borrowing for provincial corporations | | | 2,276 | 756 | 1,025 | 1,018 |
| Direct borrowing for capital purposes | | | 5,434 | 3,772 | 3,687 | 4,265 |
| Re-financing of maturing debt | | | 6,899 | 14,446 | 16,103 | 16,586 |
| Direct borrowing for the Fiscal Plan | | | 4,494 | 7,038 | 7,824 | 6,880 |
| Other | | | 5,050 | 95 | 43 | (13) |
| **Of which long term debt** | | | | **15,400** | **17,600** | **17,500** |

Source: Alberta 2018 Budget

# Alberta • 2018 Budget

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