

March 27, 2018

Working down the deficit, eyeing balanced budget by 2022-23

Highlights

- The revised deficit for 2017-18 stands at \$812 million (2.5% of GDP), a shortfall that's \$34 million larger than originally planned in Budget 2017.
- The province expects to run a \$683 million deficit in 2018-19, equivalent to 2.1% of GDP. This is technically a bit larger than the shortfall eyed in last year's budget (-\$644 million), due to \$52 million in one-time severance expenses, with the revenue outlook actually a touch better than previously forecast.
- The government is lowering the retail sales tax on auto insurance over four years and increasing the exemption threshold for the provincial payroll tax effective January 2019. There's also a new tax credit for search and rescue volunteers. An independent review of the tax system is ongoing, with recommendations to be incorporated in next year's budget.
- As part of a long-term industry strategy, the oil and gas subsidiary of Nalcor Energy will be established as a stand-alone corporation. As for the Muskrat Falls megaproject, another equity injection by the Province (of ~\$725 million) will support project completion. It's close to 90% complete at present. An independent inquiry will seek to identify core mis-steps for this project, which ran significantly over budget and was plagued by delays.
- As per the longer-term fiscal forecast, "government remains on track to return to surplus in 2022-23". The path back to balance isn't exactly a straight line, however. The budget assumes a \$507 million deficit for 2019-20, giving way to a larger \$654 million shortfall in 2020-21 (as revenues temporarily recede). The Province aims to chop the deficit to \$243 million in 2021-22, getting back in black one year later. Getting back to balance will require meaningful spending restraint—outright reductions in the final four years of the fiscal plan—and some tough fiscal decisions are still to come.
- Brent crude is assumed to average US\$63/bbl in 2018-19, below today's prevailing price of ~US\$70/bbl. Meanwhile, the Canadian dollar is seen averaging US\$0.79, not far from today's level. Official sensitivities suggest a US\$1/bbl change in Brent impacts offshore royalties by \$22 million in 2018-19.
- We'd view the budget's near-term economic assumptions as cautious. For instance, the government has assumed a 0.8% contraction in real GDP whereas a number of private sector forecasters (ourselves included) see positive real growth this year. Moreover, the outlook for the GDP price deflator is quite cautious in our estimation, reflecting an average oil price forecast that is well shy of current levels.
- Net debt is projected to end 2018-19 at \$14.64 billion (45.1% of GDP), up some \$1.04 billion vs the prior fiscal year. Net debt is expected to continue on its upward trend, growing by \$890 million in 2018-19 to reach \$15.53 billion (47.3% of GDP). For 2018-19, the interest bite (i.e., debt expenses as a share of revenue) looks to hold roughly steady at 13%.
- The longer-term fiscal plan would see net debt as a percentage of GDP peaking at just under 50% in 2020-21, before that burden gradually starts to ease (getting back to ~46% by 2022-23).
- The budget puts the 2018-19 gross borrowing requirement at \$1.45 billion, which we would characterize as manageable and relating solely to provincial requirements. Separate funding needs for N&L Hydro, equivalent to \$700 million for calendar 2018, were successfully met via earlier financings. At this point, there are no additional near-term requirements for Hydro.
- Outstanding treasury bills are due to grow by \$260 million in 2018-19, accommodated via somewhat larger weekly auctions of 3-month bills.

Newfoundland and Labrador 2018 Budget

Making progress with an eye to balancing books by 2022-23

As Newfoundland and Labrador puts earlier pronounced commodity price weakness behind, the provincial government is making fiscal progress, working down what was an outsized budget deficit and reining in the debt burden (particularly relative to earlier thinking). Near-term uncertainties and long-term challenges remain, while the Province's economic and fiscal results can be quite volatile. Still, credit the government for taking a series of meaningful actions that have helped stabilize the credit. Today's budget, titled "Building for Our Future", envisions progress on the deficit in the year ahead, en route to a balanced budget by 2022-23. There's more red ink than in last year's budget (an extra \$700 million over six years) and some serious belt-tightening required to close the fiscal hole. Still, the fiscal plan is based on a cautious near-term economic outlook and likewise incorporates a prudent forecast for oil prices (in addition to a modest "oil revenue risk adjustment" in future years). In light of pre-funding, gross borrowing needs, at \$1.45 billion for 2018-19, are lower than previously telegraphed and appear to be a manageable sum for a Province that has developed a more active investor relations strategy and found a receptive audience of late. Additional requirements have been added further out, mainly tied to Nalcor Energy.

2017-18 improves on mid-year forecast

The revised deficit for 2017-18 stands at \$812 million (2.5% of GDP), a shortfall that's \$34 million larger than originally planned in Budget 2017, resulting from severance expenses under a new collective agreement (designed to help the government realize "significant savings" over the long-term). Also note that the revised deficit represents a \$40 million improvement vs the mid-year forecast, resulting from higher revenue (including GBE and partnerships) that offset some extra expenses. So as 2017-18 draws to a close, the Province has succeeded in cutting its deficit by almost two-thirds relative to the peak level of \$2.2 billion recorded back in 2015-16.

The 2018-19 fiscal outlook...

Operating in a "difficult fiscal environment", Newfoundland and Labrador expects to run a \$683 million deficit in 2018-19, equivalent to 2.1% of GDP. That's technically a bit larger than the shortfall eyed in last year's budget (-\$644 million), due to \$52 million in one-time severance expenses, with the revenue outlook a touch better than previously forecast.

Total revenue is slated to grow 4.5% in the coming fiscal year. That includes a nice contribution from offshore royalties, up 7.5% and totaling \$1 billion. Brent crude is assumed to

average US\$63/bbl, below today's prevailing price of ~US\$70/bbl. Meanwhile, the Canadian dollar is seen averaging US\$0.79, not far from today's level.

The Province has budgeted for 2.5% expenditure growth in 2018-19, with nearly 40% of total spending steered to the health care sector and a further 10%-plus earmarked for education.

The 2018-19 fiscal framework may not include a dedicated oil revenue risk adjustment—that buffer kicks in starting in 2019-20—but we'd view the underlying economic assumptions as abundantly cautious. For instance, the government has assumed a 0.8% contraction in real GDP whereas a number of private sector forecasters (ourselves included) see positive real growth this year. Moreover, the outlook for the GDP price deflator is quite cautious in our estimation, reflecting an average oil price forecast that is well shy of current levels. Time will tell, and we'd of course caution that energy prices can be quite volatile.

Fiscal sensitivity analysis for 2018-19 suggests a US\$1/bbl change in the average Brent price is worth ~\$22 million in offshore royalties. Each one cent deviation in the exchange rate has a fiscal impact of \$17-18.5 million.

In terms of new tax measures, the government is lowering the retail sales tax on auto insurance over four years and increasing the exemption threshold for the provincial payroll tax effective January 2019. There's also a new tax credit for search and rescue volunteers. An independent review of the tax system is ongoing, with recommendations to be incorporated in next year's budget.

As in some other corners, the Province has embraced gender-based analysis for its budgeting decisions, seeking to (among other things) increase the number of women in leadership roles.

... and long-term deficit reduction plan

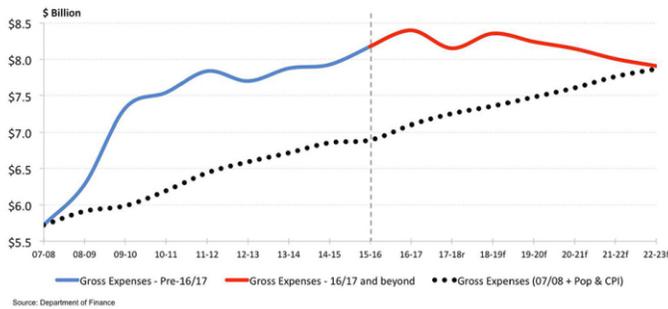
As per the longer-term fiscal forecast, "government remains on track to return to surplus in 2022-23". The path back to balance isn't exactly a straight line, however. The budget assumes a \$507 million deficit for 2019-20, giving way to a larger \$654 million shortfall in 2020-21 (as revenues temporarily recede). The Province aims to chop the deficit to \$243 million in 2021-22, getting back into the black one year later.

Overall, the five-year fiscal plan entails average annual revenue growth of 1.9%. The deficit reduction plan entails noted spending restraint. Witness the four consecutive years of declining expenditures starting in 2019-20. Achieving these cost savings will require a close examination of service delivery, identifying various efficiencies, alongside a smaller

Newfoundland and Labrador 2018 Budget

government footprint, expanded employee attrition, reduced discretionary spending, a smaller vehicle fleet, and wage restraint via new collective bargaining agreements. Suffice it to say, there are some tough fiscal decisions ahead.

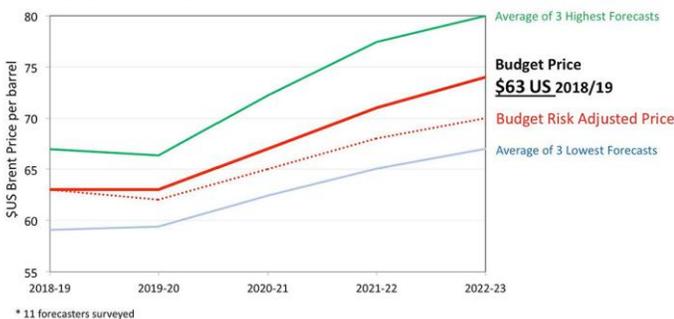
Expenditure and Growth Control



Overall, how does the new fiscal plan line up with last year's budget? Well, for the six year period covering 2017-18 to 2022-23, the cumulative budget deficit now amounts to \$2.84 billion. So there's some \$700 million of extra red ink over that six-year time horizon vs Budget 2017, driven in part by extra severance expenses.

As for longer-term energy price assumptions, the budget keeps Brent at US\$63/bbl in 2019-20, with gradual increases thereafter (reaching US\$74/bbl by 2022-23).

Oil Price Forecast



Oil price forecasts are informed by, and consistent with, the mid-point of the range offered up by 11 expert forecasters. Nonetheless, the fiscal plan incorporates an "oil revenue risk adjustment", starting at \$25 million in 2019-20 and reaching \$85 million by the end of the five-year fiscal plan.

There's noted optimism surrounding the longer-term outlook for the oil and gas sector. First oil from Hebron has arrived, bolstering the production profile. Meanwhile, first oil from the West White Rose project is expected to arrive in 2022. Healthy long-term exploration activity is encouraging. As part of a long-term industry strategy, the oil and gas subsidiary of Nalcor Energy will be established as a stand-alone corporation. As for the Muskrat Falls megaproject, another

equity injection by the Province (of -\$725 million) will support project completion. It's close to 90% complete at present. An independent inquiry will seek to identify core mis-steps for this project, which ran significantly over budget and was plagued by delays. Electricity rate mitigation is also a stated priority for the government.

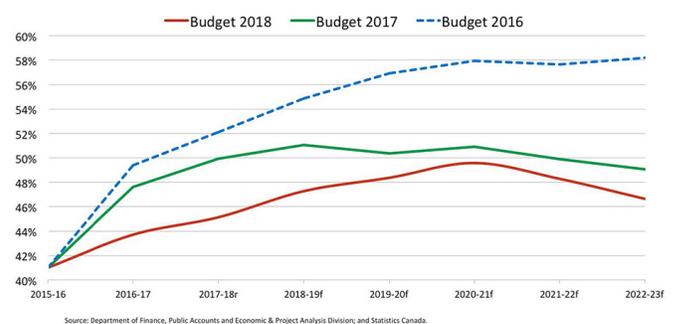
In general, major project work heavily influences the economic outlook. Following the assumed contraction in 2018, real GDP is projected to average 0.5%/year through 2022. Employment is expected to gradually contract, leaving the jobless rate averaging in/around 15% over the coming five years.

Lower debt profile, manageable borrowing needs

Net debt is projected to end 2018-19 at \$14.64 billion (45.1% of GDP), up some \$1.04 billion vs the prior fiscal year. Net debt is expected to continue on its upward trend, growing by \$890 million in 2018-19 to reach \$15.53 billion (47.3% of GDP). For 2018-19, the interest bite (i.e., debt expenses as a share of revenue) looks to hold roughly steady at 13%.

The longer-term fiscal plan would see net debt as a percentage of GDP peaking at just under 50% in 2020-21, before that burden gradually starts to ease (getting back to ~46% by 2022-23). In all cases, the latest profile for the net debt burden looks better than in the prior two budgets.

Net Debt as Per cent of GDP



The budget puts the 2018-19 gross borrowing requirement at \$1.45 billion. That's a slight step-up relative to the \$1.175 billion printed in the outgoing fiscal year. More importantly, however, the Province's gross issuance plans have been cut back relative to prior guidance. Back in Budget 2016, Newfoundland and Labrador signaled that it might need to borrow \$1.9 billion by 2018-19. That was lowered to \$1.6 billion in last year's fiscal blueprint, and has been cut back a bit more today. Further out, there's some \$1.4 billion of extra net new borrowing out to 2022-23, the bulk of which relates to Nalcor Energy. There's also a \$600 million severance

Newfoundland and Labrador 2018 Budget

payment to public sector employees, which adds to cash needs over several years but reduces non-marketable debt (i.e., a smaller government liability related to public sector employees).

We'd characterize 2018-19's \$1.45 billion bond program as manageable. The Province has adopted a more active investor relations strategy that we view as paying dividends. Moreover, we'd highlight the positive reception recently received in domestic debt capital markets. That last trip through the market took the form of a C\$300 million re-opening of the benchmark long bond (NF 3.7 10/2048s) earlier this month.

For greater clarity, the \$1.45 billion of planned long-term borrowing in fiscal 2018-19 relates solely to provincial

requirements. Separate funding needs for N&L Hydro—equivalent to \$700 million for calendar 2018—have already been successfully met via earlier debt financings. At this point, there are no additional near-term requirements for Hydro.

Finally, the debt schedule implies a \$260 million increase in outstanding treasury bills over the course of 2018-19, which will be accommodated via somewhat larger weekly bill auctions. (Relative to the status quo, an extra \$20 million a week in 3-month bills would get you there.)

Warren Lovely & Catherine Maltais

Newfoundland and Labrador 2018 Budget

Newfoundland & Labrador

\$000,000

	Budget	Forecast	Budget	Outlook			
	2017/18	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Fiscal Revenue	6,898	6,966	7,244				
<i>Provincial tax sources</i>	4,806	4,739	4,865				
<i>Personal Income Tax</i>	1,626	1,473	1,582				
<i>Sales Tax</i>	1,238	1,244	1,207				
<i>Corporate Income Tax</i>	342	300	324				
<i>Offshore Royalties</i>	882	930	1,000				
<i>Mining Tax and Royalties</i>	37	92	65				
<i>Other Taxes</i>	681	700	687				
<i>Other Provincial Sources</i>	835	985	1,071				
<i>Government of Canada</i>	1,256	1,242	1,308				
Net Income of Government Business Enterprises	441	374	429				
Total Gross Revenue	7,339	7,340	7,673	7,760	7,527	7,833	8,049
Program Expenses	7,004	7,183	7,349				
Debt Servicing	1,112	969	1,007				
Total Gross Expenses	8,116	8,152	8,356	8,242	8,146	8,006	7,908
Consolidated surplus (deficit) before adjustment	(778)	(812)	(683)	(482)	(619)	(173)	141
Revenue risk adjustment	-	-	-	(25)	(35)	(70)	(85)
Adjusted surplus (deficit)	(778)	(812)	(683)	(507)	(654)	(243)	56
as a % of revenue	-10.6%	-11.1%	-8.9%	-6.5%	-8.7%	-3.1%	0.7%
Debt servicing as a % of revenue	15.2%	13.2%	13.1%				
Offshore Royalties as a % of revenue	12.0%	12.7%	13.0%				

Net Debt and Total Debt

Net Debt, beginning of period	14,251	13,598	14,638
+ Deficit (surplus)	778	812	683
+ Acquisition of Tangible Capital Assets	479	498	487
- Amortization of Tangible Capital Assets	275	270	280
= Net Debt - End of period	15,234	14,638	15,528
of which: Borrowings net of Sinking Funds	10,847	11,660	13,048
Unfunded Pension and Retirement Benefits Liability	2,840	578	586
Deferred Pension payments - Promissory note	4,317	4,343	4,276
Other financial liabilities less financial assets	(5,706)	(4,878)	(5,410)
<i>Net debt - End of period as a % of GDP</i>	50.8%	45.1%	47.3%
Debt, beginning of period	20,498	18,405	19,515
Debt retirement, T-Bills and sinking funds	(46)	(158)	(62)
Borrowings	400	1,175	1,450
Increase in Promissory note issuance	-	-	-
Increase (decrease) in promissory notes	(65)	(63)	(67)
Increase (decrease) in unfunded pension liability	65	75	9
Increase (decrease) in post-retirement benefits liability	89	81	93
Debt, end of period	20,940	19,515	20,938

Source: Budget documents of Newfoundland & Labrador Ministry of Finance.

Newfoundland and Labrador 2018 Budget

Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Paul-André Pinsonnault

Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Krishen Rangasamy

Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault

Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau

Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms

Economist
kyle.dahms@nbc.ca

Jocelyn Paquet

Economist
jocelyn.paquet@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

National Bank Financial Inc. or an affiliate thereof, owns or controls an equity interest in TMX Group Limited ("TMX Group") and has a nominee director serving on the TMX Group's board of directors. As such, each such investment dealer may be considered to have an economic interest in the listing of securities on any exchange owned or operated by TMX Group, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange. No person or company is required to obtain products or services from TMX Group or its affiliates as a condition of any such dealer supplying or continuing to supply a product or service.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

Newfoundland and Labrador 2018 Budget

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

National Bank of Canada Financial Inc. (NBCFI), a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority (FINRA), and a member of the Securities Investor Protection Corporation (SIPC), is distributing this Report in the United States. NBCFI operates pursuant to a 15 a-6 Agreement with its Canadian affiliate, NBF Inc.

This Report has been prepared in whole or in part by **personnel** employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US **personnel** are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held in a research analyst account.

The author(s) who prepared these Reports certify that this Report accurately reflects his or her personal opinions and views about the subject company or companies and its or their securities, and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this Report as to the securities or companies.

NBF compensates the authors of this Report from a variety of sources, and such compensation is funded by the business activities of NBF including, Institutional Equity and Fixed Income Sales and Trading, Retail Sales, the correspondent clearing business and Corporate and Investment Banking.

Because the views of its personnel may differ, members of the National Bank Financial Group may have or may in the future issue Reports that are inconsistent with this Report, or that reach conclusions different from those in this Report. To make further inquiry related to this Report, United States residents should contact their NBCFI registered representative.

This document is intended for institutional investors and is not subject to all of the independence and disclosure standards under FINRA rules applicable to debt research Reports prepared for retail investors. This Report may not be independent of the proprietary interests of NBF, NBCFI, or their affiliates. NBF, NBCFI, or their affiliates may trade the securities covered in this Report for their own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendation(s) offered in this Report.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.