Newfoundland and Labrador
2018 Budget

March 27, 2018

Working down the deficit, eying 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 postive 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.

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NATIONAL BANK OF CANADA FINANCIAL MARKETS

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 postive 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.

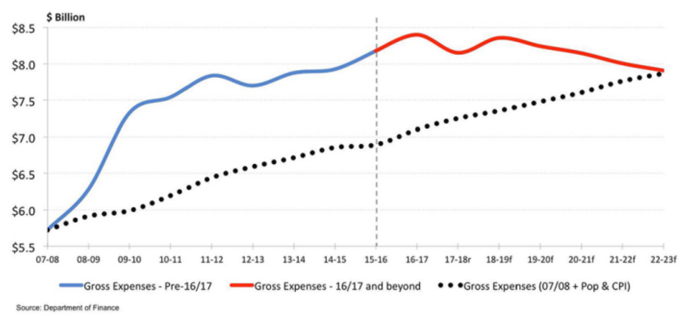
As in some other corners, the Province has embraced gender-based analysis for its budgeting decisions, seeking to (among other things) increase the number of women in leadership roles.

… 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 efficiences, alongside a smaller 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.

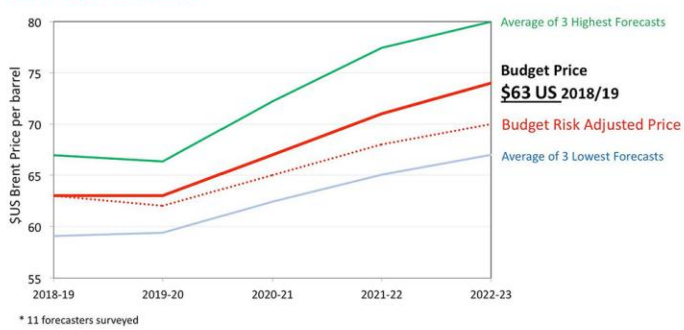
Expenditure and Growth Control



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 severence 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. Electicity rate mitigation is also a stated priority for the government.

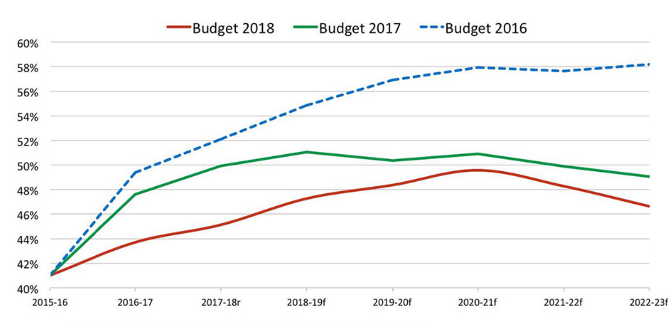
In general, major project work heavily influences the economic outlook. Following the assumed contraction in 2018, real GDP is projected to average 0.5%/year through 2022. Employment is expected to gradually contract, leaving the jobless rate averaging in/around 15% over the coming five years.

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 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

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$000,000	Budget 2017/18	Forecast 2017/18	Budget 2018/19	Outlook 2019/20	2020/21	2021/22	2022/23
Fiscal Revenue	6,898	6,966	7,244				
Provincial tax sources	4,806	4,739	4,865				
Personal Income Tax	1,626	1,473	1,582				
Sales Tax	1,238	1,244	1,207				
Corporate Income Tax	342	300	324				
Offshore Royalties	882	930	1,000				
Mining Tax and Royalties	37	92	65				
Other Taxes	*681*	*700*	*687*				
Other Provincial Sources	835	985	1,071				
Government of Canada	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)				
Net debt - End of period as a % of GDP	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 Promissary note issuance	-	-	-				
Increase (decrease) in promissary 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.

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