The Agreements on Offshore Revenues
... Redistributing Benefits to Newfoundland and Labrador and Nova Scotia

Overview
The fiscal outlook brightened for Newfoundland and Labrador (NL) and Nova Scotia (N.S.) with the new agreement on offshore revenues negotiated with the federal government. Two of Canada's most indebted Provinces, as measured by debt service per capita, are now the primary beneficiaries of their non-renewable offshore resources, with the federal government providing offset payments to each Province to ensure that their Equalization transfers are not diminished by their offshore wealth. This replaces current arrangements that trim Equalization as offshore receipts rise (please see details in text box opposite).

For NL, the new offshore revenue agreement is estimated to provide about $2.6 billion from fiscal 2004-05 (FY05) through FY12, of which $2 billion is a guaranteed floor and upfront payment. For N.S., the upfront payment is $830 million on a total $1.1 billion estimated benefit over the next eight years. These payments are in addition to Ottawa's commitment last October to raise Equalization transfers for FY05 and FY06 by $274 million for NL and $333 million for N.S.

For NL and N.S., the value of the first eight years of this new deal depends upon a number of variables, including oil & natural gas prices, future production and new projects. Also key is the provincial allocation formula for Equalization to be determined by Ottawa for FY07 onwards after an independent expert panel reports on the program.

For Ottawa, the two substantial prepayments this year will access the ample cash flow anticipated for FY05, while further payments are deferred for at least the next few years when the balance of federal revenues versus spending priorities could be considerably tighter. Through 2012, and possibly 2020, the cost of this new agreement for the federal government is substantial.

Benefits for Newfoundland and Labrador
Alongside the major upswing in international oil prices, the scheduled start-up at the White Rose field in late 2005 and additional investment interest, the offshore revenue agreement should help accomplish substantial fiscal repair. NL's cash deficit for FY05 has narrowed dramatically, from the $362 million Budget projection to an estimated $14 million. This year, higher-than-

Details of the Agreements on Offshore Revenues
- **Offshore resource receipts** (largely royalties and corporate taxes related to offshore activity) will be 100% retained by Newfoundland and Labrador (NL) and Nova Scotia (N.S.), respectively. The agreement extends beyond the Hibernia, Terra Nova and White Rose projects for NL and the Sable and Deep Panuke projects for N.S. to all future offshore resource developments in the next sixteen years.
- In the existing Canada-Newfoundland Atlantic Accord, the offset provisions will be extended one year to FY12 and will apply to both NL and N.S., since the offset provisions in the Canada-Nova Scotia Offshore Petroleum Resources Accord are less generous. The Atlantic Accord, signed in 1985, provides a two-part mechanism to ease the transition over a 12-year period once NL's cumulative offshore oil production reached 15 million barrels, as it did in FY00. The first component, the Offset floor, guarantees NL 85% of its Equalization entitlement in the previous year. The second or Phase-out component protects a share of the Equalization entitlement not sheltered by the Offset floor — 90% for the first four years, then 80% in FY04, 70% in FY05 and so on. In addition, the "generic solution" introduced in 1993 offers a 30% annual shelter for offshore revenues from Equalization impact.
- **New offset payments**, in addition to the offset payments offered in the existing Atlantic Accord, will ensure that NL and NS receive 100% of their Equalization entitlements without reductions stemming from their offshore resource receipts, as long as each Province continues to receive Equalization. From FY05 to FY12, if either NL or NS no longer qualifies for Equalization, it will still receive the offset payments stipulated in the Atlantic Accord or the generic solution. If either Province subsequently requalifies for Equalization before FY13, the offset payments of this agreement will be reinstated.
- **An up-front payment** of $2.0 billion to NL and $830 million to N.S. will serve as prepayments for the new offset payments, and represent about three-quarters of the potential benefit of this deal for each Province. After NL has booked offset payments totalling $2.0 billion on an accrual basis, the federal government will begin to transfer additional offset payments. A similar arrangement is in place for N.S. after it has received offset payments totalling $830 million. The prepayments serve as a floor. Regardless of subsequent events, such as

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expected oil prices bode well for the $62 million FY06 cash deficit projected in this spring’s Budget.

As the Province reassesses its plans with these new agreements, the extension from FY13 to FY20 appears likely. NL has a heavy burden of direct debt and its unfunded pension liability in FY04 topped 20% of provincial GDP, a much larger share than the other Provinces’. Thus its debt service per capita, when the imputed interest on its unfunded pension obligation is included, was roughly $2,000 in FY04, higher by a large margin than Nova Scotia, Quebec, New Brunswick, Ontario and Prince Edward Island. Thus even if NL accomplishes substantive fiscal repair by FY12, its per capita debt service is still expected to be higher than most other Provinces.

Specific plans for NL’s $2 billion prepayment have yet to be released. Options include retirement of a portion of NL’s direct debt or its unfunded pension liability. The Newfoundland and Labrador government is well started on an overhaul of its program expenditures to better match anticipated revenue growth. Continued prudence and efficiencies in program spending will still be important in substantially narrowing the existing fiscal gap between NL and the provincial average.

Benefits for Nova Scotia

For Premier Hamm, the offshore revenue agreement caps his Campaign for Fairness launched in 2001. In addition to the prepayment, N.S. can now fall back on the offset provisions of Newfoundland’s Atlantic Accord that are more generous than its own Offshore Petroleum Resources Accord.

A number of suggestions for the $830 million prepayment surfaced, including removal of the Harmonized Sales Tax on home heating and residential electricity costs. The Offshore/Onshore Technologies Association of Nova Scotia proposed diverting some of the windfall to exploration to kick start N.S.’s stalled offshore energy industry. The Sable project reserves have been revised lower and disappointing results from drilling in recent years have caused a number of companies to allow their exploration licenses to expire. The Province, however, committed the entire $830 million prepayment towards debt retirement, reducing interest charges by an estimated $20 million in FY06 and $40-$50 million for each full year thereafter. Fortuitously, Nova Scotia has roughly $1.6 billion of debt maturing this year. The projected annual saving on interest charges will facilitate the Province’s revised debt management plan, making it easier to achieve the objective of annual budget surpluses equal to at least the offset revenue booked each year from the $830 million upfront payment.


An eight-year extension of the offset agreements from FY13 to FY20 is possible for either NL or N.S. To be eligible, the Province must qualify for Equalization in either FY11 or FY12. For NL, the second condition is that its debt service per capita must not drop below at least four other Provinces’ (including N.S.). Debt service will be broadly defined, including imputed interest on unfunded pension and retirement benefits plus interest charges on non-self-supporting entities’ obligations and the liabilities of partners such as municipalities that cannot be refinanced.

From FY13 to FY20, if either NL or N.S. no longer qualifies for Equalization it will receive two years of transitional payments, equal to two-thirds and one-third, respectively, of the offset payments paid to the Province in the last year it received Equalization. Similar to the FY05-FY12 period, if either NL or N.S. requalifies for Equalization before FY20, it will once again receive 100% of its entitlement.

Amendments to existing agreements are not required, either to the new Equalization-Territorial Formula Financing framework or the Canada-Newfoundland Atlantic Accord for NL or the Canada-Nova Scotia Offshore Petroleum Resources Accord for N.S.

Each offshore agreement will be reviewed by March 2019, addressing issues such as its lasting economic and fiscal benefits, remaining provincial disparities and undeveloped offshore petroleum discoveries. If the federal government enters into an offshore petroleum resource revenue arrangement with another jurisdiction that NL or N.S. deems more beneficial, it can discuss possible revisions to its offshore agreement with Ottawa.

Details of the Agreements (continued)

sharply lower petroleum prices, NL and N.S. do not have to repay these amounts.

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<th>Provisonal Unfunded Pension Liabilities</th>
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Source: Dominion Bond Rating Service.

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