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Alberta: 2018–19 Q2 Update

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SUMMARY

- **The Province of Alberta recently published its *Second Quarter Fiscal Update and Economic Statement* (*Update*) for fiscal year 2018–19 (FY19).**
- **This came ahead of the Province's historic announcement that it would impose an 8.7% output cut on large oil producers in 2019 to alleviate the yawning light-heavy oil price discount. We assess the Province's fiscal position, considering both the updated Q2 economic and fiscal projections and recent policy measures.**
- **A $7.5 bn[1] deficit was forecast for FY19—narrower than in the March 22, 2018 Budget (*Budget*) and the *First Quarter Update* by $1.3 bn and $245 mn, respectively—reflecting personal income tax revenue revisions. Net debt and borrowing requirements were lowered accordingly, and black ink is still planned for 2023.**
- **The announced intervention should assist oil and gas sector revenues in FY20 but we still see downside risk to Alberta's deficit forecasts.**

ECONOMIC CONDITIONS

The Government of Alberta's economic outlook, like recent headlines, is dominated by a record-high light-heavy oil price differential that stems from insufficient transportation capacity. A widening discount lies at the root of deteriorating investor sentiment and softer capital expenditures. It also underlies scaled-back oil production as producers shut in less cost-effective assets, and expectations of weakening export volumes—a key area of recent strength for Alberta's economy. Since Q1, energy sector weakness looked to be increasingly weighing on residential construction and home sales, as the latter continued to adjust to stricter mortgage regulations implemented in January. All told, the Province foresees 2.5% real GDP growth this year—down from the 2.7% gain projected in March—with a further 50 bp downward revision in 2019 versus *Budget*.

More positive developments include continued labour market strength and resilient corporate profits. Solid job creation in the 2% range is still expected in 2018 and we highlight here the gains to date in full-time positions (chart 1, p.2). However, projected employment growth was revised lower for calendar year 2019 and the Province notes that stronger-than-anticipated inflation is eroding consumers' purchasing power. Weakness in the Canadian dollar has buttressed producers' and exporters' earnings against depressed oil prices. Forecasts for corporate net operating surpluses were lowered relative to *Budget* and Q1 estimates, but the Province still anticipates solid gains in both 2018 and 2019.

In response to the widening differential, the Government on Sunday night announced oil output restrictions for large producers that will take effect in 2019. This builds on prior plans to purchase rail cars to alleviate transportation bottlenecks. Details of the policy and our assessment can be found here. Initial

Fiscal Update
$ millions except where noted

	FY18	FY19	
	Final	Budget	Q2
Personal Income Tax	10,775	11,387	12,129
Corporate Income Tax	3,448	4,551	4,189
Carbon Levy	1,046	1,356	1,309
Other Taxes	5,492	5,605	5,575
Total Tax Revenues	**20,761**	**22,899**	**23,202**
Non-Renewable Resource Revenue	4,981	3,829	5,322
Investment Income	3,126	2,884	2,619
Other Own-Source Revenue	10,821	10,050	10,217
Total Own-Source Revenue	**39,689**	**39,662**	**41,360**
Federal Transfers	7,606	8,218	8,245
Total Revenue	**47,295**	**47,879**	**49,605**
Program Spending	**53,900**	**54,258**	**54,742**
Debt Service	659	1,027	982
General & Capital Plan Debt Service	761	895	893
Total Debt Service	1,420	1,922	1,875
Total Expenditure	55,320	56,181	56,617
Risk Adjustment	0	500	500
Consolidated Balance	**-8,023**	**-8,802**	**-7,512**
Net Financial Assets	-19,344	-29,585	-28,116
Financing Requirements	23,423	26,106	25,175
Annual Change, %			
Tax Revenue	*2.9*	*10.3*	*11.8*
Non-Renewable Resource Revenue	*60.8*	*-23.1*	*6.8*
Total Own-Source Revenue	***15.7***	***-0.1***	***4.2***
Federal Transfers	*-4.7*	*8.0*	*8.4*
Total Revenue	*11.8*	*1.2*	*4.9*
Program Spending	***3.5***	***0.7***	***1.6***
Total Expenditure	***4.2***	***1.6***	***2.3***
Memo Items, %			
Own-Source Revenue / GDP	12.0	11.3	11.8
Program Spending / GDP	16.2	15.5	15.6
Consolidated Balance / GDP	-2.4	-2.5	-2.1
Debt Service / Revenue	3.0	4.0	3.8
Net Financial Assets / GDP	-5.8	-8.5	-8.0

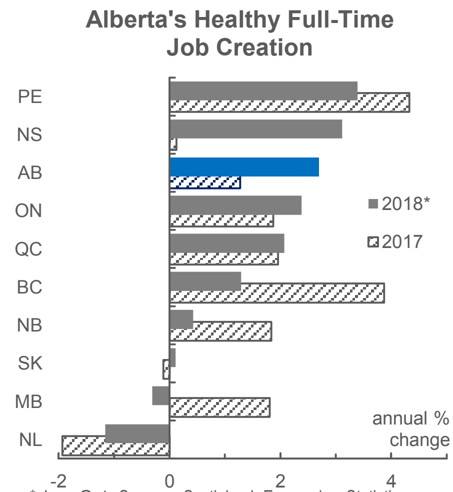
	FY18	FY19		
	Final	Budget	Q1	Q2
Bitumen royalty	2,643	1,785	2,390	2,787
Crude oil royalty	965	1,053	1,256	1,318
Natural gas and by-products royalty	645	541	591	718
Bonuses and sales of Crown leases	564	327	370	360
Rentals and fees / coal royalty	164	123	130	138
Total	**4,981**	**3,829**	**4,737**	**5,321**

Source: Alberta Finance; nominal GDP forecasts: Scotiabank Economics.

[1] Figures reported in Canadian dollars unless otherwise stated.

market response was positive: the Western Canada Select (WCS) benchmark rose more than 8 USD to narrow its discount to the West Texas Intermediate (WTI) price by 4 USD (chart 2).

Chart 1



* Jan.–Oct. Sources: Scotiabank Economics, Statistics Canada.

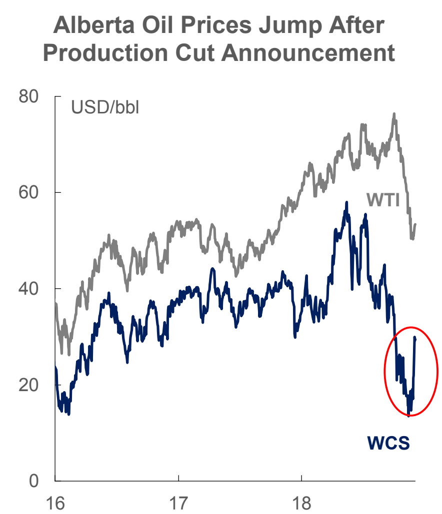
FISCAL PROJECTIONS

Revenues are expected to total $49.6 bn in FY19—$535 mn more than forecast in Q1 and $1.7 bn above the *Budget* estimate. Stronger expected personal income tax receipts stem from prior years' adjustments and a higher-than-anticipated tax base following 2017 tax return reassessments. Softer market returns and loan swap payments to the *Alberta Capital Finance Authority* are forecast to contribute to weakness beyond the downward revision in Q1 for investment income.

The effects of widened light-heavy discounts are noted in several places in the *Update*. Despite expectations of diminished bitumen production, conventional oil and bitumen royalties together were revised $459 mn higher than Q1 projections. The Government forecasts that WTI prices—on which royalty rates are based (see our commentary here)—will continue to trend higher following their recent dip and bolster royalty payments this fiscal year. However, more modest profit margins underlie a reduction of nearly $400 mn in corporate tax receipts versus Q1.

Total expenditures are expected to come in at $56.6 bn—$436 mn higher than anticipated in *Budget* and $290 mn above the Q1 projection. Additional disaster assistance—promised in Q1 following flooding and a drought in the spring, fall snow conditions and summer wildfire activity—accounts for much of both discrepancies. Operating expenses are expected to be $68 mn more than outlined in Q1 following a $47 mn upward revision versus *Budget*. Capital grants are $122 mn higher than in *Budget*—and in line with Q1 expectations—reflecting re-profiled federal funding for municipal grants and infrastructure. A $500 mn risk adjustment remains in place.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

***Alberta Capital Plan* projections for FY19 are consistent with *Budget* and Q1 estimates at $6.4 bn.** Scaled back in March after the recovery surprised on the upside, capital expenditures remain on track to retreat nearly 30% versus FY18.

DEBT AND BORROWING DETAILS

Financing requirements, estimated at $25.2 bn, are in line with Q1 plans and $900 mn lower than *Budget* projections. The Province continues to foresee direct borrowing moderately lower than planned in March for both its *Capital Plan* and *Fiscal Plan*; the former reflects the narrower projected deficit, while unanticipated federal cash transfers contributed to the latter. For the Alberta Capital Finance Authority, $194 mn more will be borrowed than planned in Q1, mirroring its softer net income profile. Long-term debt issuance of $14.4 bn is expected this fiscal year—$700 mn more than in Q1—with $11 bn borrowed to date. A $5 bn cash reserve continues to be incorporated into the financing plan.

Net financial debt's $200 mn downward revision relative to Q1 mirrors the narrower deficit forecast for FY19. The most significant line item change to the Province's balance sheet since Q1 was a $1.1 bn decline in self-supporting lending organization assets reflecting insurance cash for agriculture indemnity payments. This was offset by reduced Agriculture Financial Services Corporation liabilities alongside weaker borrowing for the *Capital Plan* and *Fiscal Plan*.

OUR TAKE

Alberta's FY19 fiscal position is largely unchanged. With no substantial revisions on the expenditure side of the ledger—stepped-up funding for disaster relief had already been foreshadowed—we do not anticipate credit rating moves at this time. Provided that the price of crude oil continues to climb over 2018–19, and with provincial government support, Alberta should be able to sidestep a significant blowout of its deficit this year brought about by a widening light-heavy oil discount. The reduction in net financial debt is encouraging, albeit expected given the narrower deficit projection, and the Province has built in prudence via a material risk adjustment as well as a sizeable cash reserve.

The deficit outlook for FY20 is somewhat murkier. Initial response to the output curtailment announcement suggests a stronger profile for WCS next year; this should assist oil and gas industry revenues in FY20 and alleviate the backlog of stranded oil shipments. However, oil production cutbacks on top of those already initiated should also weigh on export growth—cited here as a key factor underlying the softer forecast expansion—and costs associated with the rail car purchase are potentially high. Key questions are how job creation and business sentiment will adjust to the policy change, and whether any upward movement will be sufficient to offset the considerably softer revenue trajectory implied in this *Update*. Given the severity of the light-heavy discount and historic nature of the Province's intervention, both are difficult to answer at this time. We continue to monitor the situation closely.

Economic Assumptions

	2017	2018		2019	
	Actual	Budget	Q2	Budget	Q2
Real GDP, % change	4.5	2.7	2.5	2.5	2.0
Nominal GDP, % change	7.1	4.7	4.4	4.3	3.8
Employment, % change	1.0	2.0	1.9	1.7	1.4
Unemployment Rate, %	7.8	6.8	6.7	6.2	6.3
Avg. Weekly Earnings, % change	1.0	2.4	2.5	2.9	2.7
Primary Household Income, % change	4.5	4.5	4.5	4.7	4.3
Net Corporate Operating Surplus, % change	97.9	19.1	16.1	9.8	6.3
Housing Starts, 000s	29.5	30.2	26.5	32.0	27.3
Consumer Price Index, % change	1.6	2.1	2.5	1.9	1.9
Population, % change	1.2	2.1	2.5	1.9	1.9

	FY18	FY19	
	Final	Budget	Q2
WTI Oil, USD/bbl	53.69	59.00	64.00
Western Canadian Select, CAD/bbl	50.38	46.00	45.00
Light-Heavy Differential, USD/bbl	14.40	22.40	29.25
Bitumen Production, 000s bbl/day	2,804	3,163	3,051
Conventional Oil Production, 000s bbl/day	457	461	483
Natural Gas, AB Reference Price, CAD/GJ	1.82	2.00	1.50
Canadian Dollar, US¢/CAD	78.0	80.0	77.5

Source: Alberta Finance.

Balance Sheet
$ billions

	FY18	FY19	
	Final	Budget	Q2
Heritage Fund & Endowment Funds	20.3	20.8	20.8
Contingency Account	1.7	0.0	0.0
Other Financial Assets	49.0	51.2	49.7
Financial Assets	**71.0**	**72.0**	**70.4**
Liabilities for Capital Projects	29.3	33.2	33.1
Debt: Pre-1992 Teachers' Pension Plan	0.9	0.9	0.9
Direct Borrowing for *Fiscal Plan*	13.1	20.1	18.8
Pension Liabilities	9.4	9.1	9.1
Other Liabilities	37.5	38.2	36.6
Total Liabilities	**90.3**	**101.6**	**98.6**
Net Financial Assets (Debt)	**-19.3**	**-29.6**	**-28.1**

Source: Alberta Finance.

Financing Requirements
$ millions

	FY18	FY19	
	Final	Budget	Q2
Direct Borrowing: Capital	5,434	4,272	4,177
Direct Borrowing: *Fiscal Plan*	4,494	7,038	5,731
Cash Reserve	5,000	5,000	5,000
Borrowing: Orphan Well Assn.	50	145	145
Borrowing: Workign Capital	82	1,000	1,000
Term Debt: Provincial Corporations			
Agriculture Financial Services Corp.	183	406	323
Alberta Capital Finance Authority	4,162	3,760	3,924
Alberta Petroleum Marketing Commission	445	675	711
Alberta Treasury Branches	2,769	3,000	3,264
The Balancing Pool	804	810	900
Subtotal	**8,363**	**8,651**	**9,122**
Total Financing Requirements	**23,423**	**26,106**	**25,175**

Source: Alberta Finance.