LAURENTIAN BANK SECURITIES

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Newfoundland and Labrador Mid-Year Update: Revenue boost cuts short-term deficit

Minister of Finance Siobhan Coady presented on November 24th the N&L Fall Update. The government forecasts a $595M shortfall for FY 2021-22 (1.5% of GDP), representing a $231M improvement relative to budget and almost one-third of last year's $1.5B deficit. More than 80% of the revision comes from higher revenue (+$186M) with expenses tracking $45M below budget. Correspondingly, the province revised down its borrowing requirements from $1.7B to $1.5B. The province may look at borrowing the other $200M this year to hedge against further interest rate increases. N&L's financial situation is clearly more sensitive to interest rates with a debt service-to-income ratio of 11%, compared to the typical 4%-to-8% range for other provinces.

The improvement to revenue likely comes from all sources based on the general information available in the Fall Update. Retail sales and housing starts are up at a double-digit pace notably. The Ministry of Finance now forecasts 2021 nominal GDP growth, the best proxy for the tax base, at 22% following the 2020 contraction of 11%. Stronger-than-expected CPI inflation and oil prices surge boost GDP deflator by 16% this year.

Higher oil prices benefit coffers and brighten the industry's longer-term outlook

This year's bull market in oil has positively impacted Newfoundland and Labrador in several ways. First, the Ministry of Finance now expect brent prices to average US$74/bbl in FY 2021-22, US$10 more than in the Budget released in May. According to information conveyed at the press conference, the government projects to collect $23M more in offshore royalties relative to budget. Although the province revised down its 2021 oil production forecast from -5% to -9%, to 95.1M bbl/day, fiscal sensitivities suggest significantly higher royalties for FY 2021-22. Using our own US$78 bbl/day brent prices forecasts, the royalty boost could come in closer to $250M in the next fiscal update.[1]

Second, higher prices and financial support from the province have invigorated the industry. Suncor the largest shareholder in the Terra Nova extension project, announced last September its intention to continue vital maintenance of the Terra Nova platform, with production expected to resume in 2022 and continue until 2033. Cenovus, the majority owner in the West White Rose project, is more optimistic about resuming construction, with Suncor increasing its ownership stake from 28% to 40%. Norwegian Equinor also sent strong signals about moving forward the Bay du Nord project, a 300M bbls reserve of recoverable oil.

[1] Budget 2020 indicated that each incremental $1/bbl in brent oil prices yields $17.4M for the province.

Structural reforms still needed

Although this update is unambiguously positive, N&L's fiscal position remain challenging. The government should not overly rely on volatile natural resources revenues to balance the budget. The mitigation deal about Muskrat Falls with the federal government still needs to be finalized. Meanwhile, investors still wait for the implementation of critical spending and revenue measures proposed by the Greene Report released in May. For instance, among other measures, the panel recommended to implement a four-day week for public sector workers when possible, the freezing of the total public sector employees' wage bill and drastic grant reduction to higher education institutions. On the revenue side, the panel also recommended moderate HST and CIT increases.

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