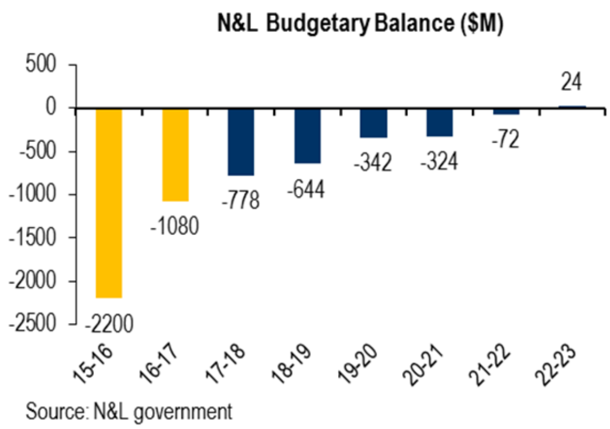
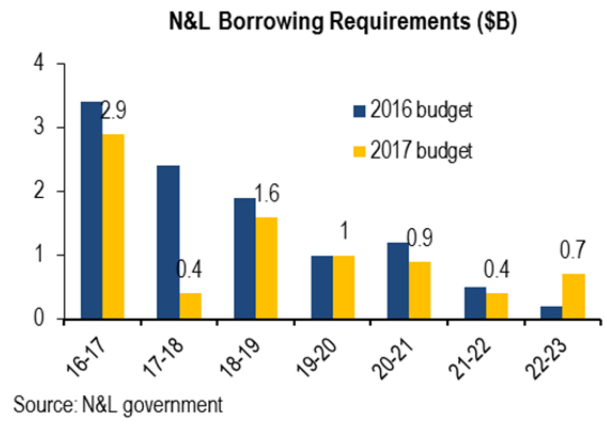
Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

The 2017 N&L Budget: Significant Progress Made Recently, Deficit Reduction Plan on Track

The N&L Liberal government has been facing an unprecedented fiscal situation when it took office in late 2015. The $2.2B deficit prompted by the decline in crude oil prices was, relative to GDP, close to the size of the U.S. federal government deficit of 2009 caused by the financial crisis.

Given the Province's extremely fragile financial situation, large tax increases were introduced in the April 2016 budget. These immediately generated much-needed non-oil revenues. After that, through out FY 2016-17, the worst case scenario investors had in mind - having very low crude oil price over a sustained period of time - dissipated. After reaching rock bottom in 2016Q1, Brent oil prices (the N&L offshore oil industry receives Brent prices for its oil) largely surpassed the US$40 per barrel assumed in the 2016 budget. Consequently, total revenues came in at $7.22B in FY 2016-17, a significant $544M improvement relative to expectations. Since the $125M contingency cushion for unexpected declines in oil prices was unused, the deficit for FY 2016-17 was revised down by $750M to $1.1B (3.6% of GDP).





Cutting the deficit by half in one year (from $2.2B in FY 2015-16 to $1.1B in FY 2016-17) is definitively a substantial financial relief for the Province. The N&L government will not need to borrow on the bond market to finance operating expenditures anymore. Instead, the Province will only tap the bond market for some debt repayment, financing infrastructure spending and to make an equity investment in Nalcor Energy (the crown corporation in charge of managing the Muskrat Falls Hydro project). Altogether, the Province's borrowing requirements are only projected at $400M in FY 2017-18, $2.0B less than expected in last year's budget. This is arguably the largest single improvement contained in the 2017 budget documents. Investors took noticed and the Province's bond yield spreads (versus the federal benchmarks) narrowed by about 10bps since then.

Since the fiscal outcome for FY 2016-17 turned out to be significantly better than expected, Finance Minister Cathy Bennet was also able to give a much-needed break to taxpayers. The gasoline tax of 16.5 cents a litre introduced last year will gradually come down to 4.5 cents on December 1st, 2017.

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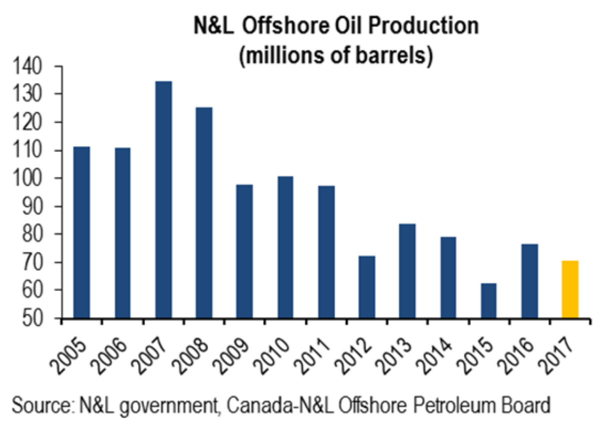
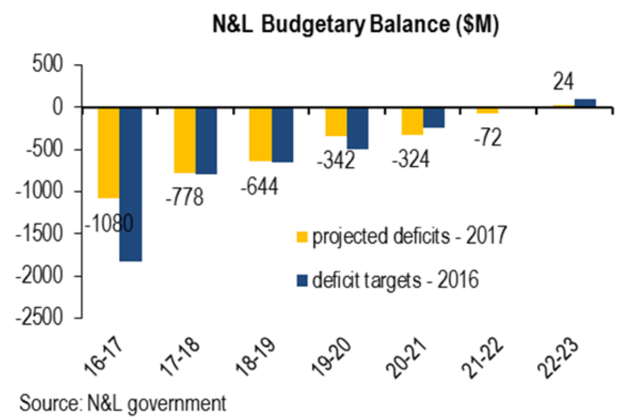
Looking forward, investors should be pleased to see that the N&L government is proposing in its 2017 budget to improve the trajectory of government's spending. This is a necessary step to reach the longer term objective of getting back into a surplus position in FY 2022-23. The goal is to offset the above trend growth in expenses that occurred before the 2014 oil shock (under the previous PC government). Accordingly, a $283M reduction (-3.4%) in spending is planned for FY 2017-18. This is expected to be the main driver to bring down the deficit further this year (to $778M; 2.5% of GDP). This belt-tightening exercise will be done primarily through small savings across all ministries and crown corporations. The N&L government says improving the efficiency of public service delivery won't require deep job cuts. But since most of the 7.7K public sector employees are without a contract, investors will need to monitor labour negotiations in order to assess whether spending will effectively be cut by promised 3.4% this year.

In our view, the N&L government's attempt to cut spending this year will contribute to reinforce the credibility of its the long-term deficit reduction plan presented last year; especially since oil royalties are perceived to be volatile. However, as we've mentioned in our Alberta and Saskatchewan budget write-ups (available at www.vmbl.ca), we are of the view that crude oil Brent prices over the coming years will most likely be above what is currently assumed in the N&L budget (US$56 in FY 2017-18, US$62 in FY 2018-19 and US$69 in FY 2019-20).

In the short-run, the beginning of the U.S. summer driving season in late May will likely reinforce the current decline in U.S. crude and gasoline inventories. Also, the consolidation phase of global oil inventories is expected to continue especially if OPEC members extend their production cuts in the second half of 2017 and stick to their agreement. This will more than compensate for rising U.S. crude oil production in the shale basins. According to our calculations, the Province's fiscal revenues could be stronger-than-expected by a modest $30M annually if our oil price projection materialises; we forecast WTI crude oil prices to reach $US67 per barrel by the end of 2017 and average close to $US70 in 2018.





The other major factor which should help the Province's fiscal outlook is the turnaround in N&L's offshore oil production. The latter is projected at 71M barrels in 2017, down 7% from last year and half the number of barrels extracted 10 years ago (due to the aging of the Hibernia, Terra Nova and White Rose fields). This being said, the production phase of the new Hebron field will begin in late 2017. Thus, total production is expected to soar near 100M barrels in 2018 and beyond. The oil royalties of the Province of N&L are thus expected to increase significantly (from $0.9B in FY 2017-18 to slightly more than $1.2B annually in the medium-term).

Conclusion: Deficit cut by half in FY 2016-17, but debt still high and rising

The improvement of the global oil outlook and the new spending discipline proposed in the 2017 budget are contributing to significantly improve the Province of N&L's fiscal position. While the Province might now be financially out of danger, it would be premature to claim that it is no longer vulnerable. Firstly, on a GDP basis, N&L is still the highly indebted (48% in FY 2016-17; 50% projected for FY 2017-18). Secondly, the $1.1B in debt servicing projected for FY 2017-18 is still the second-biggest of the spending items on the budget after health care. Thirdly, the imminent completion of oil, nickel and hydroelectricity projects will lead to a fall in capital investment and employment. Fourthly, the downtrend in the Province's population will continue (-0.5% this year), contributing to cool household spending and erode tax revenues.

These are genuine risks to the Province's fiscal outlook. This being said, investors will find comfort in the fact that the N&L government is willing to make new, yet difficult, decisions in order to prevent the Province from moving back into a more precarious situation with regards to rating agencies and accessing financial markets.

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