



## Laurentian Bank Securities **ECONOMIC RESEARCH AND STRATEGY**

### **N&L Fiscal Update – Lower Oil Revenue and Higher Spending**

Finance Minister Tom Osborne presented today an Economic and Fiscal Update for FY 2020-21. Without surprise, the COVID-19 pandemic is significantly deteriorating NL's finances, echoing recent updates released by other provinces. The NL government expects a \$2.1B deficit for the current fiscal year, a \$1.4B deterioration relative to the projection included in the 2019 Budget released in April of last year.

#### **Oil Drives Down Revenues**

The economic outlook provided in the update has changed materially. Nominal GDP for 2020 is notably 18% lower relative to the 2019 budget projection, leading the government to revise down total revenue by \$631M. The main drivers are depressed oil prices and, to a lesser extent, lower oil production. First, the Terra Nova offshore oil field will be shut down until 2021, a longer period than previously expected due to a regulatory order made in December 2019. Last year, 11.5% of the Province's total oil production came from Terra Nova. Second, the global oil supply-demand imbalance caused by COVID-19 has led to a 50% reduction in Brent Oil prices forecasts for FY 2020-21 (US\$34/bbl) relative to the 2019 budget. Accordingly, \$560M out of the \$631M downward revision to total revenue unveiled in today's fiscal update comes from offshore royalties. The US\$34 assumption is somewhat conservative in our view. Brent prices stood around US\$43 recently and averaged US\$42 since June. If oil prices remain close to this level, the Province could collect \$148M in additional revenues. Investors will also note that the fiscal framework provided today does not include the \$146M transfer the Province expects from the federal government's Safe Restart Agreement.

#### **Upward spending pressures, virus under control in the Province**

In contrast to other recent provincial fiscal updates, the upward revision to spending related to the coronavirus (+\$720M) is larger than the downward revision to revenues (-\$631M). Today's update also includes the \$200M contingency fund approved by the House of Assembly last March. Finance Minister Tom Osborne mentioned during his presentation that about \$120M has been spent so far due to COVID-19. The remaining \$80M is expected to be spent throughout this fiscal year. The good news is that the virus is under control for now. Indeed, the number of Covid-19 cases in NL remains low at 50 per 100K people, close to one-fifth of the national average (274). Part of the \$261M upward revision to health care costs comes from the purchase of personal protective equipment necessary to tackle a potential second wave. Also, modifications to financial assumptions underpinning public sector employees' pension and other benefits increase spending by \$127M in FY 2020-21.

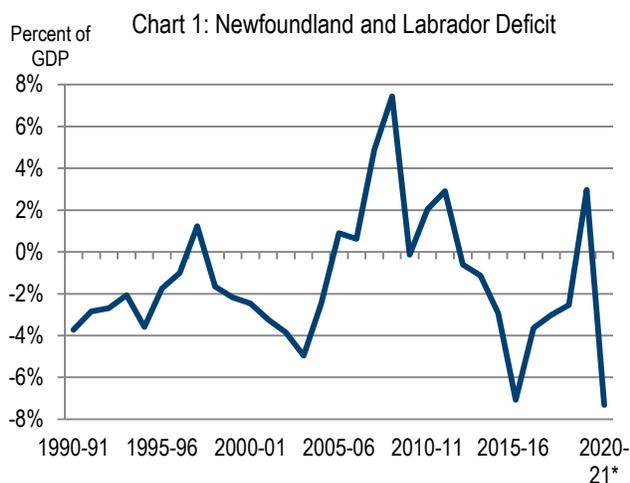
#### **A large deficit brings comparisons to the challenging situation of 2015-16**

Altogether, the NL government estimates its deficit for FY 2020-21 at \$2.1B (7% of GDP), similar to the FY 2015-16 shortfall caused by the previous oil shock (chart 1). The COVID-19 fiscal impact, as well as the commissioning of Muskrat Falls, leads to a larger financing program this year: \$3.2B in borrowing requirements, a \$2B increase from last year's expectations. As of July 24, \$1.6B (50%) of the program has been completed.

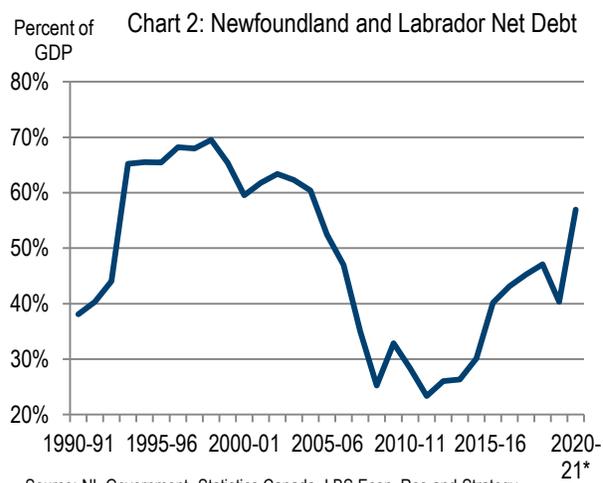
Overall, this deterioration in public finances brings comparisons to the fragile financial situation of 2015-16. The Province was able to move away a fiscal cliff with its pivotal 2016 budget, which included uneasy policy choices such as tax increases. Combined with the improving outlook for oil, the N&L government had made progress in reducing the size of its deficit prior to the pandemic (chart 1). Of course, today's challenge is different. As Finance Minister



Tom Osborne mentioned during his press conference, a vaccine will be found at some point and allow oil demand to recover. Also, we are of the view that the federal government could enhance its financial assistance to Provinces.



Source: NL Government, Statistics Canada, LBS Econ. Res and Strategy.



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### A new Premier in August and a Budget in September

Today's financial challenge is also exceptional due to the heavy debt burden. Consecutive deficits and the steep cost of Muskrat Falls (more than one-third of total public debt) led to an increase in provincial debt (chart 2). Net debt is forecast at \$16.7B in FY 2020-21, unambiguously elevated for a population of about half of million. At 57%, the debt-to-GDP ratio remains lower than during the 1990s and early 2000s periods, although that was before the development of the oil industry (chart 2). Tom Osborne plans to say more about the debt challenge in its September 2020 Budget. While ratings agency will take notice of today's update, we expect them to wait until September before making any statement. S&P has placed the province's A-rating under negative review on May 28, citing concerns about the impact of oil prices on the province's fiscal position. Moody's completed a "periodic review" of N&L A1 (negative) rating on July 22 which might inform future ratings decisions.<sup>1</sup>

Finally, before the budget, a new Liberal Party leader will be chosen on August 3 to replace Dwight Ball as Premier. The two candidates are Dr. Andrew Furey, an orthopaedic surgeon, and John Abbott, a former health deputy minister under Danny Williams' government.

**Dominique Lapointe, CFA** | Senior Economist

438 835-7626 | [lapointed@vmbi.ca](mailto:lapointed@vmbi.ca)

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<sup>1</sup> A periodic review is not a ratings decision and does not indicate a rating action is likely in the near term.