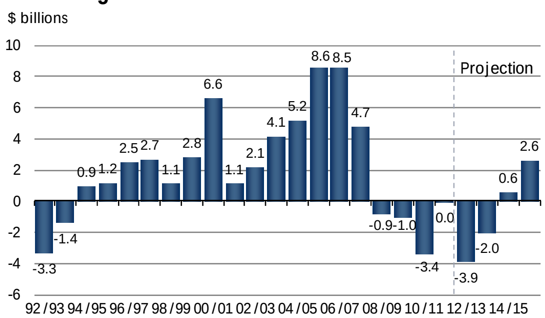
ALBERTA BUDGET 2013

March 8, 2013

Alberta government fiscal balance



Note: Balance numbers were calculated using the old methodology for comparison purpose
Source: Government of Alberta Finance, RBC Economics Research

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What a difference a year makes...

In the highly anticipated Alberta Budget, released yesterday, expectations were that 2013 would mark another year in the red for the province. Quarterly updates signalled the steep discount on crude oil prices were having an impact on year to date revenues, yet the question remained how sizable the impact would be on the province's bottom line. The third quarter update estimated the deficit for 2012/13 could be as large as $4 billion. The release of the Budget confirmed such volatility in commodity prices did have an impact on resource revenues, to the tune of a $4.1 billion drop. This resulted in the deficit rising to $3.9 billion in 2012/13 from the $0.9 billion projected in Budget 2012. However, the number was not stated in Budget 2013 with the Alberta government introducing a new fiscal framework.

Revised Fiscal Framework

As was alluded to in various news reports prior to its release, Budget 2013 shook up the province's fiscal framework by dividing its fiscal plan into three entities. A new fiscal management act brings in place an operational plan, a savings plan, and a capital plan. The motivation underlying the change was presented as a means to institute legislated savings and "set Alberta on the path towards less reliance on non-renewable resource revenues". The consequence being deficit projections going forward would not be comparable to those prior to this shift in budgeting structure.

Fiscal Year 2012/13

Based on the former methodology and for comparison purposes, the FY2012/13 budget deficit would be $3.9 billion. This is compared to the province's initial estimate of an $882 million deficit in Budget 2012. A 36% plunge in revenue resources contributed to total revenues falling 6% from the Budget 2012 estimate to $37.9 billion. Corporate and personal income taxes were stronger while a 29% gain in investment income also provided some offset. Operating expenses rose 1.0% to $38.0 billion.

To offset a steep drop in non-renewable resource revenues, the province's former Sustainability Fund's assets were "sold to draw out the $6 billion to fund government operations and various cash needs in 2012/13". As of April 1, 2013, the long-term fund, set up to offset volatility in public balances stemming from the energy sector, will see its balance fall from $2.7 billion to $691 million (The fund balance was $7.5 billion on March 31, 2012). As part of the fiscal framework restructuring, this Sustainability Fund will now be known as the Contingency Account with its primary purpose to act solely as a short-term fiscal shock absorber. The account will be funded through a percentage of non-renewable resource revenues being diverted annually to achieve a target account balance of 15% of operating revenues.

Components of New Fiscal Framework

- **Savings Plan**

As part of the Savings Plan, non-renewable resource revenues will be deducted by law from operating revenue each year. This legislated savings policy outlines these withdrawals as 5% of the first $10 billion in non-renewable resource revenues, rising to 25% for the next $5 billion and 50% for revenues in excess of $15 billion. Once the fund reaches a balance of $5 billion, any excess savings will be diverted to the Heritage Fund or other provincial endowments. The projected balance of this Contingency Account is $1.4 billion in 2014/15 and $4.5 billion in 2015/16 on the assumption that over the medium term there is "an expected steady expansion in oil sands production".

- **Operating Plan**

The operating plan consists of operating revenues and operating expenses and as a result of the new framework, can only run an operating deficit if there is money in the contingency account to fund it.

The revenue profile has been shifted down from Budget 2012 on account of revised resource revenue projections with projections reduced by an annual average of $7.1 billion between 2013/14 and 2015/16. Total revenues are projected to rise by 1.8% in 2013/14 to $38.6 billion. Initially these revenues were projected to rise by 9.2%. Total revenues are expected to recover, rising by 8.5% in 2014/15 and 7.4% in 2015/16. This expected recovery will largely be supported by resource revenues surging 14.7% and 18.4% respectively, after a 1.1% gain in 2013/14. Underlying this projection is the assumption of "substantial growth in bitumen royalties and rising prices and production". Other revenues are set to increase by $162 million (3.3%) in 2013/14 with land sales in Fort McMurray contributing 93% ($150 million).

Expenses are projected to decline by 1.1% in 2013/14 largely on account of a $477 million drop (70%) in the provision for disaster/emergency assistance. Total expenses are slated to then rise 2% in 2014/15 and 2015/16 as a result of a 2% increase in operating expenses (net of in-year savings) each year. Health and education spending make up 60% of operational expenses in 2013/14 with $17.1 and $6.2 billion allocated to each, respectively. Health spending is projected to increase 2.4% on average through to 2015/16 while education is expected to rise 2.1% annually, on average, in the same period. This holding of expenditure growth well below its 10 year average in part relies on a three-year wage freeze for "management, opted-out and excluded staff" in the Alberta Public sector and a reduction in public sector managers by 10% over this period.

- **Capital Plan**

The capital plan is the final branch of the new fiscal framework and like the savings plan, is linked to the operating plan through operating revenues. 85% of the plan will be funded through direct borrowing, on average, in the next 3 years. Annual debt servicing costs will be limited to a maximum of 3% of the province's operating revenue (the average of revenue from the current year and prior two years). In 2013/14, this 3% threshold is $1.1 billion; however, capital debt servicing costs are projected to come in well below at $238 million.

For 2013/14 through to 2015/16, capital spending is expected to average $5 billion annually, declining from $5.5 billion in 2012/13 to $4.6 billion in 2015/16. Through the forecast horizon, the capital plan is expected to be largely funded by direct borrowing with the province expecting to borrow $12.7 billion by the end of 2015/16. Financing for the capital plan includes issuing debt with various terms of maturity, extending out to at most 30 years. A capital debt repayment plan aims to set aside amounts annually based on amounts borrowed and interest rates to align debt repayments with maturities. For 2013/14, $72 million will be set aside to cover $32 million in current principal repayments and $40 million allocated for future repayments. In 2014/15, this number jumps to $1.1 billion, in part to fund $944 million in expected current year principal repayments.

Economic Assumptions

Operating revenues make up an integral part to the new fiscal framework and rely on prices in the volatile energy sector. Like Budget 2012, the key energy assumptions in Budget 2013 are in line with the average of private sector forecasts, however, are significantly lower than the projections laid out one year ago. The WTI price is expected to remain relatively flat ($92.5 US$/bbl in 2013/14 and $92 US$/bbl in 2015/16) largely as a result of "ongoing rapid supply growth from North American non-conventional oil production and sluggish demand growth from a protracted US recovery". The WCS price is expected to improve from $68.21 Cdn$/bbl in 2013/14 to $75.74 Cdn$/bbl in 2015/16 (Initially estimated to be $91.23 Cdn$/bbl for 2013/14 in Budget 2012). As a result, the price differential will be 27% in 2013/14, narrowing to 19% by 2015/16. This improvement relies on the assumption that pipeline capacity will expand and an improvement in US and global energy markets will enable oil sands production to increase 21% through the forecast horizon.

The Western Texas Intermediate price is broadly in line with RBC's forecast for 2013 at $91 US$/bbl, however, a slight recovery is projected in 2014 to $96 US$/bbl and holding at $95 US$/bbl over the longer term. This could indicate the province is incorporating a higher degree of prudence going forward given the volatility in commodity prices that plagued the fiscal balance in 2012/13. Real GDP growth in the province is forecast to be 2.9% in 2013 (RBC's current forecasted increase is 3.5% though our revised outlook, to be released mid-March, is likely to show a downward revision to 3%), unchanged from the third quarter estimate, yet down from the 3.8% projection in Budget 2012.

Balance Projections

One year ago, Budget 2012 projected a return to surplus in 2013/14. The intervening period has been marked by volatile commodity prices, particularly a sizable discount for the province's Western Canadian Select crude oil, that obviated any hope that the current deficit profile would remain intact. Based on the former methodology, Budget 2013 resulted in this return to balance being pushed back one year to 2014/15 making 2013/14 the sixth consecutive budget deficit for the province. On account of sizable reductions to resource revenue projections, the 2013/14 deficit is projected to be $2.0 billion. (Operating revenues less operating expenses, allocation for capital plan debt servicing costs and capital grants). The province would return to surplus in 2014/15 with a budget balance of $555 million followed by $2.6 billion in 2015/16.

Financial/Borrowing requirements

The Alberta government forecasts long-term public borrowing requirements of $7.3 billion in 2013/14 with $3.2 billion to fund the capital plan and $4.1 billion to lend to crown corporations. The budget documents indicate $7.1 billion in borrowing is planned for 2014/15, falling to $5.7 billion in 2015/16. This marks an increase from total financing requirements of $3.7 billion in 2011/12 and the $3.5 billion estimate for 2012/13 in Budget 2012 (Now forecast to be $6 billion).

Conclusion

Beneath the new fiscal framework, the Alberta government has roughly maintained its deficit profile, however the lower starting point has delayed the return to surplus by one year. The government has adopted projections for oil prices and economic growth that are broadly in line with RBC's own forecasts. Revenues are highly sensitive to swings in the energy markets, however; a bounce back in resource revenues is dependent on a recovery in the energy sector, with assumptions based upon pipeline capacity expansions and production increases. According to the budget sensitivities, revenues underlying this projection could come in 10-15% above or below current estimates depending on volatility in energy prices, exchange rates, economic growth or equity markets.

Alberta's fiscal plan

$ billions	Actual	Forecast	Estimate	Budget 2013 Target	
	2011-12	**2012-13**	**2013-14**	**2014-15**	**2015-16**
(1) Revenue	39.5	37.9	38.6	41.9	45.0
(2) Program expense	-	-	37.6	-	-
(3) Debt servicing costs	0.4	0.4	0.4	0.4	0.4
(4) Expense	35.7	38.4	38.0	38.8	39.6
(5) Allocation for capital plan debt servicing costs			0.2		
(6) Capital grants			2.3		
Surplus/ (deficit) (1-(2+3+5+6))	**0.0**	**-3.9**	**-2.0**	**0.6**	**2.6**

Revenue and expense numbers are based on the new fiscal framework.

Balance numbers were calculated using the old methodology for comparison purpose.