

ALBERTA FISCAL UPDATE 2014

November 26, 2014

Pricing in the oil price plunge...just not yet

A much anticipated mid-year update on fiscal developments in Alberta, released by Alberta Treasury Board and Finance today, did not mark a material shift in sentiment from the upbeat picture presented at the time of the March budget (or the Q1 update released in August) despite the sharp drop in crude oil prices that has occurred in the intervening period. There was speculation leading up to today's update regarding the extent to which the more than 30% drop in oil prices that began this summer would impact the bottom line of the energy-dependent province; however, stronger-than-expected performance in the first six months of the fiscal year is expected to more than offset the dampening effect that is projected in the latter half of 2014/15. This does imply, however, that downward pressure will intensify in 2015/16, particularly if prices remain at low levels on a sustained basis. The mid-year report does not include updated projections beyond the current fiscal year and so, the speculation will likely continue for upcoming budgets.

Higher resource revenues despite sharp drop in crude oil prices....

Stronger-than-expected energy prices boosted the province back into surplus in 2013/14, a year sooner than initially projected and this strength carried into the early part of fiscal year 2014/15 providing some cushion for the developments that have occurred since the summer. Resource revenues are actually forecasted to be higher in 2014/15 than initially projected in the March budget (up \$146 million to \$9.4 billion) as the impact of lower oil prices is more than offset by a weaker Canadian dollar and a lower light-heavy oil price differential. (The latter has been supported by strong demand for Alberta's heavy crude oil and the increasing use of crude-by-rail). The government did account for an oil price impact by lowering its WTI forecast to \$88.88/bbl in 2014/15 from \$95.22/bbl forecast in Budget 2014 (reflecting a forecast of \$75/bbl for the final six months of 2014/15 after tracking at \$100.08 in the first six months). In contrast, the WTI-WCS differential is forecasted to narrow to US\$18/bbl in 2014/15 from the \$25/bbl projected at the time of the March budget.

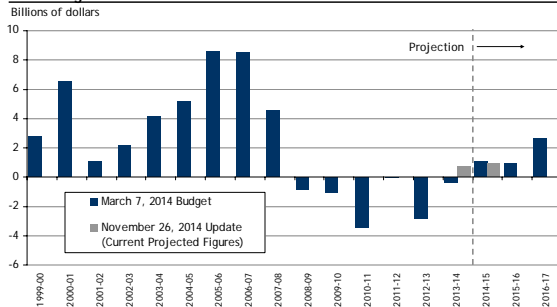
...though implies downward pressure beyond 2014/15

The government did highlight that the sharp decline in oil prices will dampen government revenues and weigh on corporate profits and household incomes, although this is not expected to materialize in the current fiscal year. On account of robust household income growth, personal income taxes are forecasted to boost total revenues this year while a base effect from higher-than-expected corporate profits in 2013/14 set up the province for further revenue strength. Beyond the current fiscal year, however, nominal GDP, the broadest indicator of the tax base, is now forecasted to slow significantly—to 0.9% in 2015 from 7.3% in 2014 and an initial budget forecast for 2015 of 4.7%. In contrast, a revision to real GDP was minimal with growth forecasted to come in at 3.8% in 2014 and 2.8% in 2015 (compared to 3.7% and 3.0%, respectively, in Budget 2014).

Deteriorating budgetary balance on account of rising expenditures

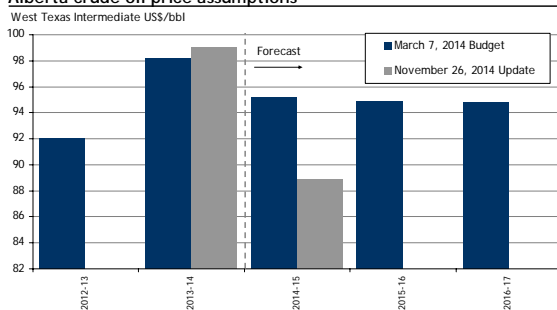
Even with the outperformance in revenues in 2014/15, the government lowered its projected surplus to account for an unanticipated \$791 million lift to expenditures that include higher costs for disaster assistance and an increase

Alberta government fiscal balance



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

Alberta crude oil price assumptions



Source: Alberta Treasury Board and Finance, RBC Economics Research

Laura Cooper

Economist

(416) 974-8593

laura.cooper@rbc.com

in grants for post-secondary institutions. A \$154 million deterioration in the overall balance for 2014/15 since the budget reflects these higher-than-expected expenditures more than offsetting the upward revision of \$637 million in revenues. The budget balance is now estimated to come in at \$933 million compared to \$1,087 in the March budget.

Uncertainty looms for 2015/16 but bright spots remain

With a potentially dark cloud of uncertainty looming on the province's fiscal situation for 2015/16, some silver linings remain. Real economic growth is forecasted to remain robust, supported by solid population growth, strong housing markets, and elevated levels of consumer spending. While the government noted that weaker oil prices will "take some heat out of the economy next year", rising oil sands production is expected to remain a key driver of economic growth, as projects increasingly shift to the production phase which will, in turn, boost the volume of provincial exports. The government largely maintained its projection for crude oil production (at 582K and 2300K barrels per day for conventional crude and raw bitumen, respectively, from 583K and 2347K in the Budget).

Today's mid-year report provides a 'marking-to-market' of the fiscal performance year-to-date and does not provide updated projections beyond the current 2014/15 fiscal year. A weaker nominal economic growth picture is likely to compound what is projected to be weak fiscal performance in the remaining months of 2014/15 and as such, could weigh on the government's ability to maintain its current trajectory of budget surpluses over 2015/16 and 2016/17 (of \$941 million and \$2.7 billion, respectively). At the same time, however, the government made a strong point today of noting that should challenges weigh on the revenue side, it will align expenditures accordingly. The volatile nature of the government's key source of revenue— non-renewable resource revenues accounted for close to 20% of total government revenues in 2013/14—have contributed to sizeable swings in the budget balance in the past, so this degree of caution is a welcome development. We expect that as supply conditions gradually normalize and oil prices retrace some of the recent outsized decline (with our current tentative forecast for WTI prices to come in at US\$86.50/bbl in 2015 and US\$85.00/bbl in 2016), significant expenditure restraint may not be needed and the province may once again remain resilient in the face of resource revenue challenges.

Fiscal year assumptions (Year-over-year % change)	Budget				Mid-Year Update	
	2014	2015	2016	2017	2014	2015
Real GDP growth	3.7	3.0	2.7	2.9	3.8	2.8
Nominal GDP growth	6.1	4.7	4.8	5.3	7.3	0.9
Crude oil prices - WTI US\$/bbl	98.2	95.2	94.9	94.8	99.1	88.9
Crude oil prices - WCS CDN\$/bbl	78.5	77.2	76.6	78.1	80.1	78.1
3-month Treasury bill rate*	1.0	1.0	1.3	2.0	1.0	1.0
Ten-year government bond rate*	2.5	3.1	3.7	4.0	2.4	2.7
Unemployment rate	4.4	4.3	4.3	4.3	4.6	4.5

* %, end of period

Source: Alberta Treasury Board and Finance, RBC Economics Research

Alberta's fiscal plan

\$ billions	Budget 2014		Fiscal Update	Budget Projections	
	2013-14	2014-2015	2014-15	2015-16	2016-17
Operational Plan					
Net Operational Revenue	43.7	43.1	43.7	44.0	46.3
Operational Expense:					
Operating Expense (net of in-year savings)	37.1	38.5	38.7	39.9	40.9
Endowment Fund / Account Expense	0.2	0.2	0.3	0.3	0.3
2013 Alberta Flood Assistance	3.6	0.2	0.2	0.1	0.0
Provision for Disaster / Emergency Assistance	0.1	0.2	0.3	0.2	0.2
Amortization / Inventory Consumption	1.0	1.0	1.0	1.1	1.1
General Debt Servicing Costs	0.4	0.4	0.4	0.4	0.6
Total Operational Expense	42.4	40.4	41.0	41.9	43.1
Operational Surplus	1.4	2.6	2.7	2.0	3.2
Savings Plan					
Contingency Account	4.7	5.0	5.0	5.0	5.0
Heritage Savings Trust Fund:					
Alberta Future Fund	-	0.2		0.4	0.7
Advanced Education Endowment	1.2	1.4		1.4	1.5
Agriculture and Food Innovation Endowment	-	0.2		0.2	0.2
Social Innovation Endowment	-	0.5		1.1	1.1
Other	13.9	12.8		12.8	13.6
HSTF Total	15.1	15.1		16.0	17.2
Medical Research Endowment Fund	1.4	1.4		1.4	1.4
Science and Engineering Endowment Fund	0.8	0.8		0.9	0.9
Scholarship Fund	0.8	1.0		1.0	1.1
Cancer Prevention Legacy Fund	0.5	0.5		0.5	0.5
Total Balance	23.2	23.9		24.8	26.0
Total Annual Savings	1.8	0.7		0.9	1.2
Capital Plan					
Capital Plan Spending					
Investing in Families and Communities	2.3	3.0		2.9	2.7
2013 Alberta Flood Assistance	0.2	0.4		0.3	0.2
Securing Alberta's Economic Future	2.6	2.9		3.1	2.9
Resource Stewardship	0.3	0.3		0.4	0.2
Legislative Assembly	0.0	0.0		0.0	0.0
Total Capital Plan Spending	5.4	6.6	7.3	6.6	6.0
Capital Plan Financing:					
Direct Borrowing*	3.6	4.9	2.2	4.6	2.7
Alternative Financing	0.4	0.2	0.2	0.3	0.5
Transfer from Contingency Account	-	0.8	3.3	1.2	2.3
Revenue Received for Capital Purposes	0.5	0.6	0.6	0.5	0.4
Other	1.0	0.2	0.2	0.2	0.1
Total Capital Plan Financing	5.4	6.6	7.3	6.6	6.0
Capital Debt Servicing Costs	0.2	0.4	0.3	0.6	0.8
% of Operational Revenue	0.6%	1.0%	0.8%	1.4%	1.8%

* Excludes \$905 million of refinancing in 2014-15.

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

