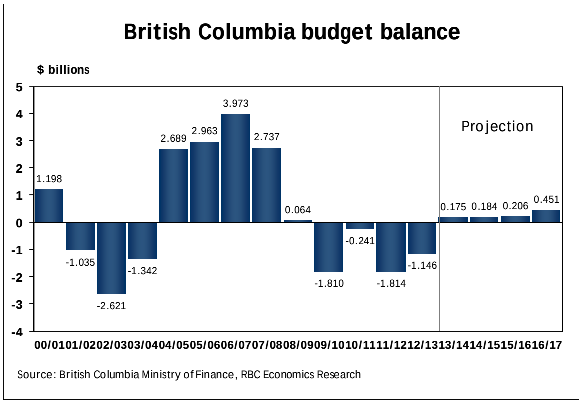
BRITISH COLUMBIA BUDGET 2014

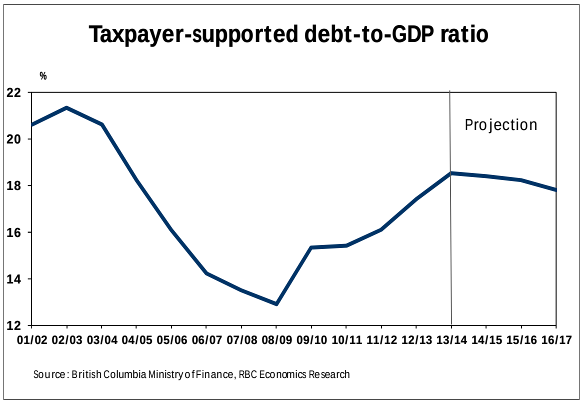
February 19, 2014

The new era of budget surpluses; LNG tax rules revealed

The buzz heading into the 2014 budget in British Columbia probably had less to do with the fiscal plan itself and much more with the (very) long-awaited liquefied natural gas (LNG) tax regime promised by the BC government months ago. The yet-to-be-born LNG industry in the province is thought to have potentially transformative power for the BC economy, with tens of billions of dollars in investment and tens of thousands of jobs all supposedly waiting for the right tax regime to be announced. In the event, Finance Minister Michael de Jong indeed provided a first glance at what his government will introduce – a two-tier tax on liquefaction income; however, we will have to wait a little longer until the fall of 2014 for the final details and legislation.



As for the fiscal plan, there were few surprises on the main revenue and expense accounts. As expected, the budget will be in surplus each year of the plan: $184 million in 2014/15, $206 million in 2015/16 and $451 million in 2016/17. Moreover, the surplus for the fiscal year ending next month was revised slightly higher to $175 million from $165 million projected in the second quarter update released in November and $153 million in the June 2013 budget.



By and large, the government is maintaining the course set last year. Budget 2013 contained several tax and spending measures (including increases in the corporate and personal income tax rates), as well as the sale of assets, to reverse a larger-than-expected shortfall the previous year. With the plan succeeding at balancing the books in 2013/14, Budget 2014 stuck to last year's script and included few new measures of substance.

Perhaps the main surprise was in the capital account profile, where the government plans to boost capital spending relative to its earlier intentions, and significantly so in 2014/15. In part, this will represent a reallocation of funds previously slated for 2013/14. Despite the stronger capital spending, however, the taxpayer-support debt profile was downwardly revised, partly reflecting a lower starting point in 2013/14.

First glance at BC's LNG plan

As promised, Minister de Jong provided a first glance at his government's proposed tax regime for the LNG industry in a brief 'backgrounder' accompanying the budget plan. The government will adopt a two-tier LNG income tax, with a tier-one tax rate of 1.5% and a tier-two rate of up to 7%. The regime will tax income from liquefaction of natural gas in the province, regardless of whether it is destined for the export market or for domestic use. The document indicates that the tier-one tax rate will apply to an operator's net proceeds (revenue less expenses) after commercial production begins. The tier-two tax rate will apply to net income less up to 100% of a capital account (calculated

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based on the construction costs of the LNG facility). In effect, the tier-two tax will kick in only once the capital invested has been recouped. Moreover, tier-one tax paid during the early years of production will be deductable from tier-two tax, further delaying the application of the full tier-two rate.

The BC government indicated that the tier-two rate and special tax features will continue to be reviewed until legislation is introduced in the fall of 2014. The government re-iterated its commitment to putting in place a “competitive” tax regime. It remains to be seen whether LNG project proponents will find sufficient answers in yesterday’s announcement to proceed with approval decisions or to stay on the sidelines until the final details are determined later this year. Some of the more than dozen projects in the province already have cleared environmental reviews, hold natural gas licenses and lined up clients, and in theory, are motivated to go (under the right framework)..

It should be noted that the fiscal plan does not book any revenue from an LNG income tax.

Budget 2014 highlights

The implementation of revenue-boosting initiatives is expected to lift the **revenue side of the ledger** by 1.9% to $44.8 billion in 2014/15. The personal tax increase for incomes greater than $150K announced in last year’s budget (which kicked in January 1, 2014) and the reversal of Budget 2013’s basic personal amount tax credit enhancement are contributing a $403 million boost to personal income tax revenues which are slated to rise by 9.6% to $7.5 billion. Strengthening consumer expenditure is projected to lift sales tax revenues (7% to $6.0 billion) while an increase in tobacco taxes ($3.20 per carton) and higher medical service plan premiums (effective January 1, 2015) are expected to more than offset a 10.6% drop in property transfer tax revenues as a result of changes to Homeowner Grants and a forecasted slowing in housing market activity. While accounting for a smaller share of revenues, higher anticipated prices and production volumes of natural gas are forecasted to boost natural gas royalties 19.8% to $441 million in 2014/15, supporting a 6.2% lift to natural resource revenues, to $3.0 billion in 2014/15. A 1.5% dip in federal transfers to $7.4 billion is expected to temper the overall revenue gain.

Taking into account a weaker-than-expected starting point for revenues in 2013/14, the rest of the **revenue profile** remains little changed over the forecast horizon. Revenues are slated to rise 2.8% to $44.8 billion in 2015/16 (compared to 1.3% to $44.8 billion in Budget 2013) supported by a 3.9% rise in personal income taxes. Extending the fiscal plan to 2016/17 shows revenues rising by 3.2% to $47.5 billion that year. Over the forecast horizon, natural gas royalties are expected to rise 13.2% and 16.2% in 2015/16 and 2016/17, respectively; however, this component will continue to make up a relatively modest (18%) share of natural resource revenues by 2016/17. The two-tier LNG income tax, announced yesterday and to be introduced in the legislature this fall, has not been incorporated into these revenue estimates.

On the other side of the ledger, **expenditures** are slated to rise 1.7% to $44.4 billion in 2014/15. Health and education, which make up 50% of total expenditures, are projected to increase by 3% to $16.9 billion and 0.4% to $5.4 billion, respectively. A projected volume increase in healthcare services delivered by organizations funded by the government is expected to boost the Service Delivery Agency Expense by 2.1% to $27.8 billion; however, this is projected to be partially offset by own-funding generated by these agencies. The continued inclusion of savings through ‘expenditure management’ accounts for $76 million in savings while an additional $26 million in savings is yet to be identified in 2014/15.

Savings on the expenditure side in 2013/14 are expected to result in firmer expenditure growth in 2014/15 (1.7% rise compared to 1.2% in Budget 2013) with stronger annual expenditure growth carrying through the rest of the fiscal plan (rising by 2.7% and 2.4% in 2015/16 and 2016/17, respectively). While total expenditures are projected to rise, the vast majority of all departments will see little change between 2015/16 and 2016/17. The few departments driving the increase include health, rising by 2.8% and 2.6% in each of the outer years, respectively, and social development and social innovation, slated to rise 1.6% and 0.6% in 2015/16 and 2016/17, respectively. Moreover, the core review savings have shifted from the Budget 2013 profile contributing in part to the revised expenditure growth outlook. Budget 2014 assumes $102 million in expenditure savings for 2014/15, compared to $30 million and $50 million across 2013/14 and 2014/15, respectively, in Budget 2013, although the impact on the 2014/15 expenditure level is negligible given the lower-than-expected expenditure estimate in 2013/14. The fiscal plan’s extension to 2016/17 also resulted in the previously allocated $50 million in savings in 2015/16 to be spread out, with $25 million in savings now expected in 2015/16 and $22 million in 2016/17. The relatively small amounts indicate that even in the absence of these expenditure savings, however, the stronger expenditure growth profile would not limit the province from remaining in surplus throughout the projection period.

Taxpayer-supported capital spending is projected to surge by 16.3% to $4.0 billion in 2014/15, although this jump partially reflects downwardly revised capital spending in 2013/14 (now expected to be 6.9% lower than projected in Budget 2013). All components of tax-payer capital spending are slated to rise in 2014/15, led by a 32.8% jump in post-secondary education spending to replace and renew existing infrastructure. An earlier anticipated pullback in taxpayer-supported capital spending in 2014/15 has instead been deferred to 2015/16, when it is projected to decline by 9.1%, followed by a further 10.5% drop in 2016/17 as capital projects are completed.

Despite higher capital spending, the **taxpayer-supported debt** profile was lowered, in part reflecting better outcomes in 2013/14 (larger surplus, lower capital spending). Taxpayer-supported debt is now projected to rise from $41.9 billion in 2013/14 to $45.5 billion by 2016/17. As a share of GDP, however, taxpayer-supported debt will gradually decline from 18.5% in 2013/14 to 17.8% in 2016/17, thanks to strengthening economic growth.

The budget documents show **total borrowing requirements** of $13.7 billion over the fiscal plan, with $10.7 to be allocated for capital spending and $3 billion to be directed to retire maturing debt over the next three years. In 2014/15, provincial borrowing is expected to be $5.4 billion ($5.1 billion in new borrowing and $0.3 billion in direct borrowing by Crown corporations and agencies), representing a decline from $7.5 billion in 2013/14 as new borrowing is projected to drop by 29%.

Conservative assumptions

The fiscal plan presented in Budget 2014 continues the usual practice of embedding conservative assumptions and other prudence factors. First, the government assumes that real GDP in the province will grow by 2.0% in 2014, 2.3% in 2015 and 2.5% in 2016. This profile is weaker than our forecast of 2.4% in 2014 and 2.8% in 2015. Second, the plan also maintains a forecast allowance of $200 million in 2014/15, rising to $325 million in 2016/17. And third, the plan contains contingencies totalling $1.3 billion over three years. These factors should bring some degree of protection against unexpected slippage on the revenue or expenditure fronts to ensure that the budget stays in the black until 2016/17.

British Columbia's fiscal plan

$ billions	Actual	Forecast	Estimate	Plan	Plan
	12/13	**13/14**	**14/15**	**15/16**	**16/17**
Revenue	42.1	44.0	44.8	46.0	47.5
Expense	43.2	43.7	44.4	45.6	46.7
Surplus (before fcst allowance)	-1.146	0.275	0.384	0.431	0.776
Forecast allowance	0	-0.100	-0.200	-0.225	-0.325
Surplus	-1.146	0.175	0.184	0.206	0.451