October 27, 2015

A LONGER ROAD BACK TO BALANCE

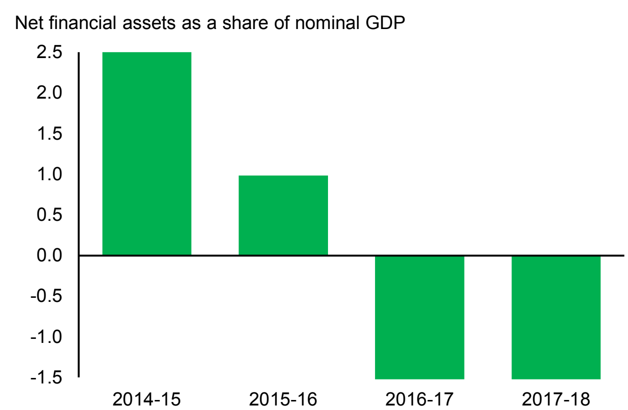
Highlights

- In its first budget since being elected in May, the Alberta government has estimated a deficit of $6.1 billion in fiscal 2015-16 (1.8% of GDP). A return to budgetary balance has been projected by fiscal 2019-20 – one year later than contained in its pre-election platform. The deficit is expected to narrow steadily over the course of the plan.
- Modest spending growth targets have been set. Total expenditures are estimated to rise 3.2% in fiscal 2015-16, before averaging annual gains of 2.1% until it returns to balance. Revenues are assumed to drop 11.5% in fiscal 2015-16, and rise thereafter in line with an improving economy and oil prices.
- After implementing a number of significant personal and corporate income tax hikes prior to Budget 2015, today's document contained relatively small new revenue-raising initiatives. They include a 4 cent increase in the locomotive fuel tax rate, a $5 per carton hike for cigarettes and a 1 percentage point increase in insurance premiums. Alberta will still have no provincial sales tax.
- The government also introduced measures aimed at diversifying the Alberta economy. They include a job creation incentive program and improved access to capital for growing business.
- Capital spending totaling $34 billion has been earmarked over the next five years. The government relied on input from former Bank of Canada Governor David Dodge to help guide its plan. The government will tap debt markets to finance the infrastructure spending. As a result, the Province is on track to move from a net asset position in fiscal 2015-16 (+1% of GDP) to a net debt position as high as -3.5% of GDP by fiscal 2017-18.

The Alberta NDP government tabled its first budget today, outlining a five-year plan that aims to gradually return the province's books to balance. Relative to the government's pre-election platform, the projected profile of near-term deficits has been raised and the deficit-elimination target date pushed back by one year. These adjustments reflect in large part the further deterioration in the oil price environment since the government took office, leading to a reduction in projected revenues. On the spending side, both health care and education budgets have been protected, with overall operating outlays poised to grow at a moderate 3% this year and 2% in years thereafter.

In order to provide some stimulus to the economy, the government has committed to invest $34 billion over the next five years in infrastructure-related investments. Input provided by former Bank of Canada Governor David Dodge was used to help guide the capital plan. The government also introduced initiatives aimed at promoting jobs and economic diversification.

CHART 1: ALBERTA TO TRANSFORM TO A NET DEBT POSITION



Source: 2015 Alberta Budget.

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TABLE 1: ALBERTA GOVERNMENT FISCAL POSITION [Millions of C$, unless otherwise noted]						
	Actual	Estimate	Target			
Fiscal Year	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
REVENUE	**49,481**	**43,788**	**45,710**	**47,919**	**51,400**	**55,300**
% change		-11.5	4.4	4.8	7.3	7.6
RESOURCE REVENUES	8,948	2,768	3,412	4,365	--	--
% change		-69.1	23.3	27.9	--	--
OTHER REVENUES	40,533	41,020	42,298	43,554	--	--
%change		1.2	3.1	3.0	--	--
EXPENDITURE	**48,366**	**49,906**	**51,127**	**52,285**	**53,500**	**54,300**
% change		3.2	2.4	2.3	2.3	1.5
PROGRAM SPENDING	**47,644**	**49,128**	**50,208**	**51,018**	**--**	**--**
% change		3.1	2.2	1.6	--	--
DEBT SERVICING COSTS	**722**	**778**	**919**	**1,267**	**--**	**--**
% revenues	1.5	1.8	2.0	2.6	--	--
SURPLUS (+)/DEFICIT (-)	**1,115**	**-6,118**	**-5,417**	**-4,366**	**-2,100**	**1,000**
% of GDP	0.3	-1.8	**-1.6**	**-1.2**	**-0.5**	**0.2**
BORROWING AS A % OF GDP	3.5%	5.7%	7.7%	10.0%	--	--
NET FINANCIAL ASSETS	**13,054**	**3,392**	**-5,659**	**-13,714**	**--**	**--**
(financial assets less liabilities)						
% of GDP	3.6	1.0	-1.6	-3.7	--	--
CONTIGENCY ACCOUNT	**4,658**	**6,529**	**3,289**	**-**	**--**	**400**
HERITAGE SAVINGS TRUST FUND	**15,006**	**15,171**	**15,442**	**15,733**	**--**	**--**

Note: All figures are presented on a Consolidated Financial Statement Basis.
Source: 2015 Alberta Budget

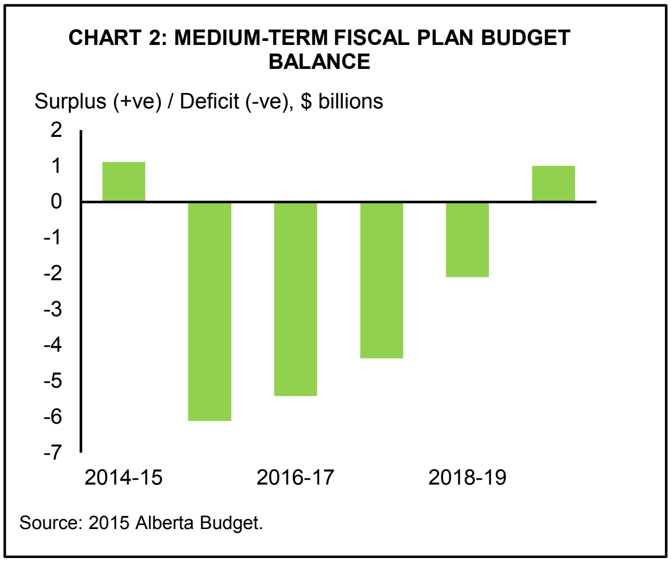
Plenty of pre-budget announcements to chew on….

Today's budget contained few surprises, since most of the big-ticket measures had already been announced and implemented following the government's election victory in May. Some of the more notable announcements include:

- Corporate taxes were increased from 10% to 12%, which took effect July 1, 2015. The income tax system was also made more progressive by introducing new tax brackets for incomes greater than 125,000 (see table 2 for more details). These changes were implemented October 1st, 2015.
- As of October 1st, the minimum wage increased by $1 to $11.20 per hour (the election platform called for the minimum wage to increase to $15 per hour by 2018).
- A royalty review panel was created in late June and will conclude its work by the end of this year. The government has committed to maintain the current royalty framework until January 2017. This will help companies budget for the winter drilling season. If and when changes are made, any incremental revenue will go to the Alberta Heritage Fund.
- The government updated its expiring regulations governing carbon emissions. The existing $15 per tonne levy will increase to $20 per tonne in 2016 and $30 per tonne by 2017. The government also created an advisory panel on climate change which will aim to have its preliminary proposals ahead of the COP21 world summit in December.
- Advisory panels on the economy and mental health were also created.
- The government also established a new Ministry of Economic Development and Trade. The mandate of the new ministry is to provide leadership on the government's

Table 2: Alberta's New Personal Income Tax Structure		
Taxable Income	**Tax Rate (%)**	
	2015	**2016 and Later**
0$ to 125,000	10.0	10.0
$125,000 to $150,000	10.5	12.0
$150,000 to $175,000	10.8	13.0
$200,000 to $300,000	11.0	14.0
$300,000 and up	11.3	15.0

Source: 2015 Alberta Budget



economic development efforts, and single-door access to information and support for businesses and investors. The ministry will develop and implement an economic growth and diversification plan for Alberta.

…and some new ones

One of the new key themes in today's budget was the need to reduce the vulnerability of the Alberta economy to oil price shocks. And, the government proposes to do so by facilitating business development and the diversification of the Alberta economy. The government plans to take three key steps to help promote growth of small to medium sized businesses.

First, the government will dedicate $2.1 billion to help promote better access to capital for small and medium sized businesses. The plan will provide ATB financial with an additional $1.5 billion to lend out to small and medium sized businesses. The government also plans to invest $50 million into the Alberta Enterprise Corporation over the next two years, to help support the creation of a venture capital market in the province. In addition the government will direct the Alberta Investment Management Corporation to invest 3% of the Alberta Heritage Savings Fund into Alberta growth-orientated companies.

Second, the government has introduced a 2-year, $178 million job creation plan. The government will provide eligible businesses and non-profit organizations with a $5,000 grant for every new job created. The plan is expected to create 27,000 jobs per year through 2017.

Lastly, the government will help provide businesses with support through development agencies and associations through the newly established Ministry of Economic development and Trade. In addition, the government will provide $10 million to community economic development initiatives.

Outside of these efforts to improve economic diversity, the government also introduced the following revenue-raising initiatives. The full-year impact of these measures is estimated at $254 million in fiscal 2016-17, dwarfed by the $1.4 billion in generated revenue from the previously announced changes to the personal and corporate tax systems.

- The locomotive fuel tax rate will increase by 4 cents.
- Tobacco tax rates will rise by $5 per carton of cigarettes.
- Insurance premium tax rates will increase by 1 percentage point.

Low oil prices wreak havoc on revenues

The drop in oil prices since July 2014 and its impact on resource revenues has been the main culprit behind the swift negative turn in fiscal fortunes for the Province this fiscal year. Indeed, non-renewable resource revenues (NRR) account for a significant portion of revenue intake. A January report by the government illustrated that over the past ten years, NRR have accounted for around 30% of total government revenues on average. This year, NRR will account for roughly 6% of total revenues. Indeed, even with the previously announced changes to the tax system and new initiatives included in this Budget, total revenues in fiscal 2015-16 are projected to be only $400 million higher relative to the March 2015 Budget.

In its 2015Q1 fiscal update, the government had estimat-

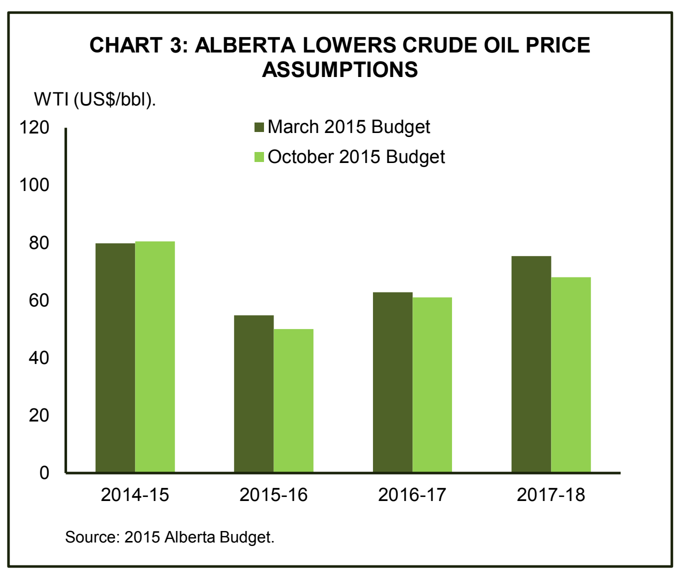


TABLE 3: ECONOMIC ASSUMPTIONS [Annual percent change unless noted otherwise]				
	Actual*	Forecast		
	2014-15	2015-16	2016-17	2017-18
Real GDP*	4.4	-1.0	0.9	2.4
Nominal GDP*	8.5	-9.4	4.0	6.3
Exchange rate (USD/CAD)	88.0	78.0	80.0	82.0
WTI (US$ per barrel)	80.5	50.0	61.0	68.0
WTI-WCS (US$ per barrel)	17.3	13.6	16.3	18.5
Natural gas** (US$/MMBTU)	3.51	2.60	2.80	3.20

*GDP numbers are estimates and are based on a calendar year. For example, 2014/2015 estimates are for calendar year 2014.
**Alberta reference price adjusted for exchange rate and transportation costs.
Source: 2015 Alberta Budget, Bloomberg and Haver Analytics.

ed a $5.9 billion deficit in fiscal 2015-16 largely reflecting a 60% drop in NRR. This was based on the assumption that the West Texas Intermediate (WTI) price of oil averaged US$59 in fiscal 2015-16. The lower oil price forecast assumed in today's budget translates into a widening of the deficit to an estimated $6.1 billion this fiscal year. NRRs are now expected to fall 69% in fiscal 2015-16, before averaging gains of 26% over the next two fiscal years – but will remain less than half the level recorded in fiscal 2014-15.

Key to the outlook for NRR is the assumptions surrounding oil prices (for both heavy and light oil), oil production, producer costs and the Canadian dollar. The government assumes that the West Texas Intermediate (WTI) price of oil will average US$50 per barrel in fiscal 2015-16, US$61 per barrel in fiscal 2016-17 and US$68 per barrel in fiscal 2017-18. These estimates are consistent with our own forecast. The spread between WTI and Western Canada Select (WCS) is projected to average around US$14 per barrel in fiscal 2015-16. However, the government notes that oil production is expected to rise (reflecting increased output from non-conventional sites) as existing projects expand and more projects come on line while pipeline access to refineries and ports remains insufficient. As a result, the spread is forecast to widen to US$18.50 by fiscal 17-18. Producer costs are estimated to ease as labour and other key input costs remain supressed. The Canadian dollar is forecast to average 78 US cents in fiscal 2015-16 which will slightly mitigate the effects from lower oil prices (see Table 3 for more details regarding economic assumptions).

Other revenue streams have also been impacted by the low oil price environment. The government estimates corporate profits to drop 55% in 2015 and remain below 2014 levels through fiscal 2017-18 due to a weaker oil price environment. The higher tax rate on corporations will likely help provide a modest offset to the impact of lower profits, raising an additional $250 million of taxes in fiscal 2015-2016 and $450 million in fiscal 2016-2017. However, corporate income tax revenue is still expected to fall 18% in fiscal 2015-16 and is projected to average tepid gains of 1.1% over the next two fiscal years.

Personal income tax revenue intake is estimated at $12 billion in fiscal 2015-16, up 9% from the previous year. The government notes that this reflects the impact of recently undertaken tax measures, which are expected to generate additional revenues of $450 million in fiscal 2015-16 and $906 million in fiscal 2016-17. Removing these measures and prior-years' adjustments, PIT would grow a much more moderate 3.7% this year. Over the following two fiscal years, PIT is projected to rise 4.6% per year (annual average base increase of 3.9%) – well below the gains recorded in recent years.

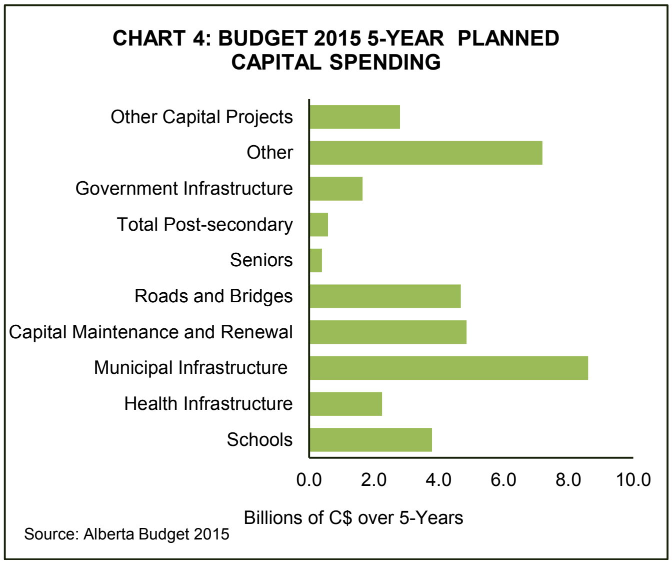
When all is said and done, total revenues are projected to decline 11.5% to $43.8 billion in fiscal 2015-16. In fiscal 2016-17, total revenues are expected to increase 4.4%, 4.8% in fiscal 2017-18 and average 7.4% gains over the final two years of the plan.

Program spending to be curtailed but key public services will be stabilized

Program spending is projected to grow moderately over the forecast horizon. The government has been forthright in highlighting that funding towards health and education will be restored following proposed cuts in the March Budget.

Total expenses for fiscal 2015-16 are estimated at $49.9 billion, up 3.2% or $1.5 billion from fiscal 2014-15. Looking ahead, total growth in spending will slow slightly– averaging annual gains of 2.1% until the government returns to balance. This yields a small decline in real per capita terms. Health consolidated expense is expected to rise 2.2% in fiscal 2015-16, while education spending is expected to be held essentially flat (+0.2%). Over the following two fiscal years, both ministries are set to increase at an average annual rate of 3.1%. Disaster/Emergency Assistance funding rose by more than $500 million in 2015-16, reflecting additional expenses related to forest firefighting and agricultural assistance.

While the government has indicated that there are increases in front-line staffing levels for school boards and Alberta Health Services, it remains focused on hiring restraint to control total compensation costs. After rising 3.9% in fiscal 2015-16, total compensation costs are expected to grow at an average rate of 2.5% over the next two fiscal years.



Government pledges $34 billion to investment in infrastructure

Based on the recommendations of former Bank of Canada governor David Dodge, the government has dedicated $34 billion towards investment in infrastructure over the next five years – a $4.5 billion increase relative to the March budget. Over three-quarters of the new infrastructure spending introduced in this budget is planned for fiscal years 2016-2017 and 2017-18. The money will be spent to support municipal infrastructure, improve transit, roads and bridges, support local water and waste water projects, expand and improve healthcare facilities (including funding the new cancer care facility in Calgary), invest in schools (including opening 200 new schools and investing in post-secondary education facilities), provide adequate senior housing and long-term care facilities, and complete flood recovery and mitigation projects (see chart 3).

Amid deficits, the investment in new infrastructure is expected to be fully funded through new debt. Total borrowing for the capital plan is estimated to be $18 billion in 2015-2016 and reach $31.8 billion by 2017-18 – accounting for almost 90% of Alberta's projected borrowing over the next four years. As a result, total borrowing as a share of nominal GDP is projected to rise from 5.7% in 2015-16 to 10% in 2017-18. Moreover, Alberta's current net financial asset position is poised to transform into a net debt position by fiscal 2016-17, rising as high as 3.7% of GDP by fiscal 2017-18.

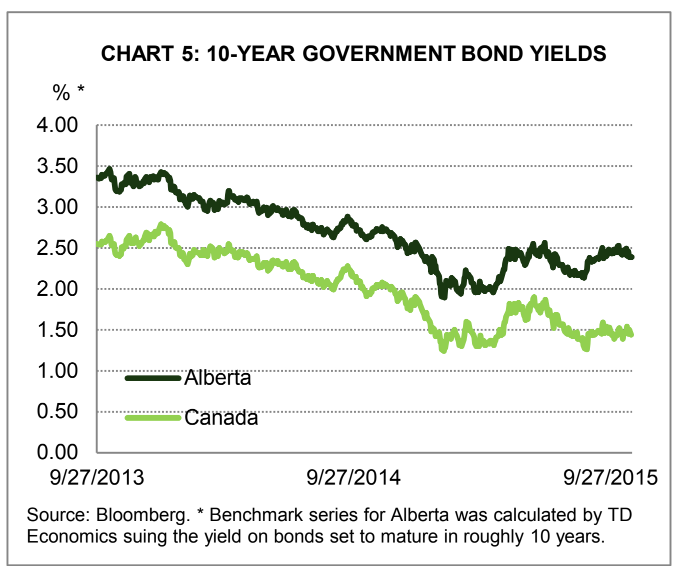
The government will also draw down on its contigency account, which will fall to zero by fiscal 2016-17. Once the government returns to a surplus position in fiscal 2019-20, the contingency account will be begin to be replenished.

The government introduced a new Fiscal Planning and Transparency Act which sets the limit on defined government debt at 15% of GDP.

Bond markets have already priced in some risk associated with Alberta's deteriorating fiscal position in recent months, and the yields on Government of Alberta bonds have increased relative to their provincial counterparts (see chart 5). However, the cost of borrowing for the Government of Alberta remains historically low.

Economic outlook downgraded alongside lower-for-longer oil price forecast

The government has downgraded its real GDP forecast for the Alberta economy relative to the 2015Q1 fiscal update. The government estimates a contraction in real GDP growth in 2015 (-1%), followed by a moderate pick-up in activity over the 2016-19 period (see Table 3 on page 4) in line with the gradual increase in oil prices. The decline in activity in 2015 largely reflects the pullback in capital spending (investment in the oil sector is projected to decline 34%) tied to weak oil prices. The hit to nominal GDP is even more striking. Nominal GDP is forecast to decline 9.4% this year, before rising 4.0% in 2016 and 6.3% in 2016. As nominal GDP provides a good proxy for revenue in-take, the drop in nominal GDP this year is echoed in the fiscal plan. The government highlights that its capital plan will provide a boost to real GDP and employment. The plan is expected to create 8,000 to 10,000 jobs and boost real GDP by 0.5% over 5 years. TD Economics' GDP forecasts for Alberta are very much in-line with the government's call for 2015 and, like the government, we assume a return to economic



growth – albeit moderate – in outer years.

Bottom line

The government tabled a budget with few surprises. After announcing a slew of new initiatives since taking power in May, today's budget outlined a medium-term plan to get back to balance. A conservative oil price assumption forecast translates into a relatively slower growth trajectory in revenues and a more drawn out road to balance. Program spending is set to grow moderately, though below gains in projected revenues. The continued commitment to infrastructure investment will give the economy a short-run boost while addressing long-term infrastructure needs for the province. And, given its excellent credit rating, the government can access debt markets relatively cheaply in order to finance these projects.