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Alberta Fiscal Snapshot

Alberta Limits Fiscal Damage but Still Not on a Path to Balance.

BRIEFING MARCH 2019

Key Findings

- Alberta's economic rebound has hit a bump—the unexpected collapse in oil prices that has dampened growth and revenue projections.
- A swift response from the provincial government has limited the impact of low oil prices on royalties and corporate tax revenues, but provincial coffers remain dependent on volatile resource revenues, which will be lower over the near term.
- Despite recent spending restraint, the Alberta government continues to spend at the second-highest per capita rate in the country.
- The province is expected to continue to run large deficits over the near term. While Alberta's debt burden is small compared with other provinces, its rising debt levels and persistent deficits are unsustainable.

Overview

After enduring one of the longest and deepest recessions in Canadian history, the Alberta economy saw a modest recovery in 2017 and 2018. Revenue growth advanced at a double-digit pace that was close to where it was before the oil price crash of 2014 and 2015. But just when the province was enjoying the relief of some steady increases in oil prices, another plunge occurred in the later part of 2018. The nascent economic and fiscal recovery hit a major roadblock.

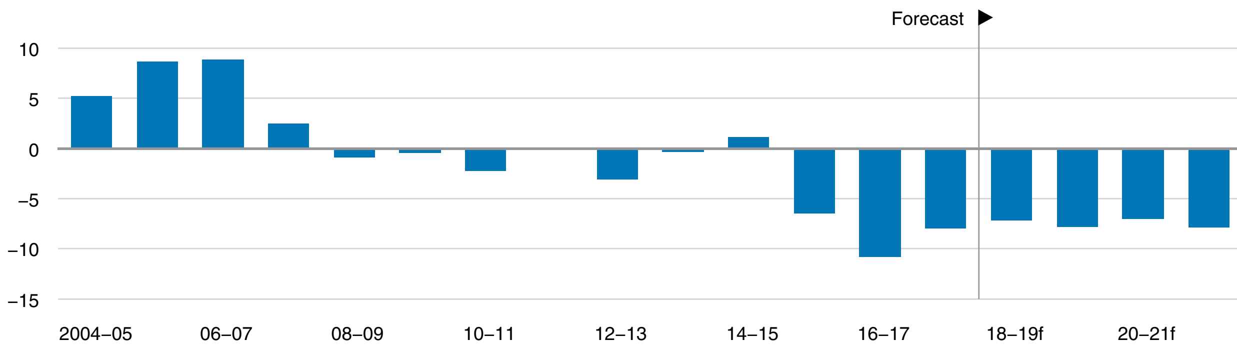
Despite the drop in oil prices at the tail end of 2018, we estimate that provincial government revenues will manage to post decent growth for fiscal year 2018–19. Still, the revenue growth will be much slower than what we saw in the previous fiscal year. Combined with modest expenditure control (an overall increase in spending of just 2.3 per cent), we estimate that the government will be able to reduce its large deficit by $700 million, to $7.2 billion, in fiscal 2018–19.

Our outlook for economic growth and gains in government revenue is considerably less rosy for 2019–20. The province's finances are being hurt by the wide discount that Canadian oil producers have received compared with West Texas Intermediate (WTI) prices. That discount was particularly problematic at the end of 2018 due to refinery and transportation bottlenecks. However, thanks to quick government action in the form of mandatory production cuts, the discount, which peaked at over US$46 at one point in October, declined to more reasonable levels.[1] The production cuts have managed to limit the damage to royalty and corporate income tax revenues. However, revenues will record only minimal growth in fiscal 2019–20.

While the production cuts have helped, the government continues to avoid making the major spending cuts or tax increases required to set the province's finances on a more sustainable path over the medium and long terms. The province has the second-highest per capita spending in the country and remains the lowest taxed. The government believes that its existing plans are sufficient to reach balance in 2023–24. Our outlook, however, suggests the province is not on a path to balance. (See Chart 1.) These persistent deficits will continue to weigh on debt in the province and we estimate that net debt will nearly triple from its 2017–18 level by 2021–22, going from $20.2 billion to $58.6 billion.

1 *Oil Sands Magazine*, "Monthly Average CDN Heavy Oil Discount," https://www.oilsandsmagazine.com/energy-statistics/oil-and-gas-prices#Cdndiscount.

Chart 1
Fiscal Balance, Alberta
($ billions)



f = forecast
Sources: The Conference Board of Canada; Alberta Ministry of Treasury Board and Finance; Statistics Canada.

Economy Takes Hit From Falling Oil Prices

The decline in Canadian and world oil prices in the later part of 2018 has put a damper on Alberta's economic prospects for 2019. (See "Tumbling Oil Prices Raise Fears.") We expect growth to be a modest 1.3 per cent in 2019. Despite the oil price woes, we think the province will avoid slipping into recession over the near term. Real energy output has remained surprisingly strong over the past few years, and that will continue as companies with existing installed capacity have little choice but to continue producing in order to earn at least some return on their investment. Investment has been hit much harder than production, and weak energy investment will remain a huge challenge for the sector's future production potential. We forecast that world oil prices will gradually recover, but they will remain low compared with the close to US$100 per barrel prices for WTI that we saw in early 2014. Consequently, real GDP in Alberta, which routinely grew in the 4 per cent range prior to the 2008–09 recession, will grow by about 2 per cent per year over the medium term.

Tumbling Oil Prices Raise Fears

For most of 2018, the economy of Alberta performed well. The recovery from the 2014–15 recession was in full swing, all sectors of the economy were growing, and investment was beginning to return to the oil sands. However, in October, a major shock hit the province. The prices it could fetch for its oil tumbled dramatically, putting the recovery and the government's finances in doubt.

The crisis centred on the price of Western Canadian Select (WCS) oil. WCS is a blended heavy oil benchmark consisting primarily of non-upgraded diluted bitumen. Though just one of the many oil products that Alberta produces, the WCS price has become the de facto benchmark for the value of oil from Alberta's oil sands. Since 2005, WCS has, on average, fetched a price US$18 below the North American standard WTI oil price. This discount reflects the fact that WCS is a heavier, more difficult-to-refine oil and that it is expensive to transport to refineries due to transportation bottlenecks.

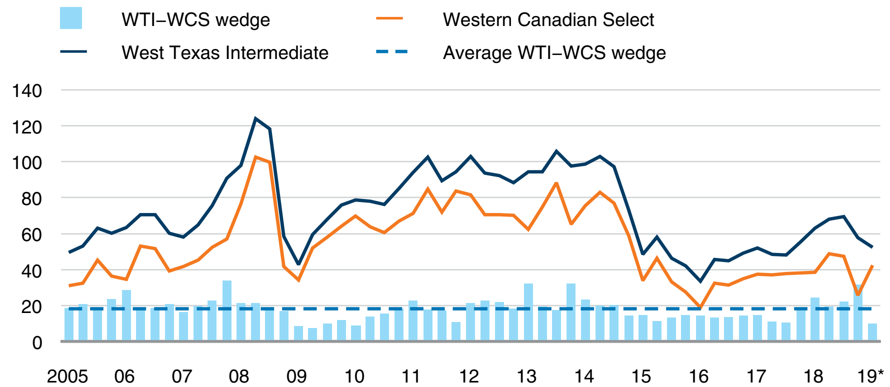
Starting in late October 2018, several factors conspired to exacerbate the WCS discount versus WTI. First, several major refineries shut down for maintenance, including the largest single destination for WCS oil, a BP refinery in Whiting, Indiana. Second, with pipeline projects, such as the Trans Mountain Expansion (TMX) and Keystone XL (KXL) projects, facing delays, rising oil sands production has increasingly forced producers to ship by rail, a costlier mode of transportation. Third, as the WCS price fell, producers began to store more and more oil. With storage facilities reaching capacity limits over the past few months, producers had no other option but to sell their product at heavily discounted prices to buyers at U.S. refineries. The result was a perfect storm that drove the WCS discount to more than US$40 per barrel, or more than twice the typical discount. (See Chart 2.)

The factors producing this perfect storm were mostly temporary, and we anticipated that they would resolve themselves with time. So far, that has been the case. The refinery at Whiting came back on line at the end of November. And the first new refinery in Canada in 34 years opened near Edmonton at the end of 2018, further easing refining pressures. Timelines for the TMX and KXL pipelines remain uncertain, but Enbridge's Line 3 pipeline will come on line at the end of 2019.

Chart 2

Alberta Government Watching WTI–WCS Wedge Closely

(US$ per barrel)



*Daily average up to February 19th, 2019
Sources: The Conference Board of Canada; world oil prices.

On December 2, 2018, Alberta Premier Rachel Notley announced that her government was imposing mandatory production cuts on oil producers in the province. The goal was to raise the price of WCS by restricting supply. The production limit was initially set at 3.56 million barrels per day, equivalent to a reduction of 325,000 barrels per day. At the end of January 2019, in response to rising prices for WCS, the production cap was increased by 75,000 barrels to 3.63 million barrels per day.[2] Based on our estimates of the WCS price and the timing of the curtailment in production, we project that overall production of mineral fuels will grow by 2.1 per cent this year, which is well below the 6.0 per cent growth we could expect to see if the government had not imposed production cuts. By comparison, oil production grew 6.4 per cent last year.

2 The Canadian Press, "'Not Out of the Woods': Alberta Easing Oil Production Cuts as Price Improves," *Financial Post*, January 30, 2019, https://business.financialpost.com/pmn/business-pmn/cp-newsalert-premier-rachel-notley-says-alberta-to-ease-oil-production-cuts.

The production cuts had a dramatic impact on prices. In the two days after the cuts were announced, the value of WCS rose from US$16.93 to US$34.25. It has since risen further and has been above US$40 since early January. Since the beginning of 2019, the WTI–WCS discount has averaged US$10.03, about half its historical level.

Around the same time that it announced the cuts, and as an additional measure to help shrink the WCS discount, the Alberta government also announced its intention to purchase enough rail cars to transport 120,000 barrels of oil per day—a plan it reconfirmed in February.[3] These rail cars will not be in service for another year, and by that time much of the pressure on WCS will have already been resolved. Nevertheless, the ability to deliver more oil by rail to refineries in the United States and Canada will contribute to the longer-term transportation capacity of the province and should help bridge the gap between capacity and supply over the medium term—particularly crucial in light of the ongoing delays in the development of pipelines.

Provincial Revenues Remain Dependent on Volatile Resource Revenues

Given the recent weakness in oil prices, our revenue forecast for 2019–20 is considerably weaker than projected in Alberta's recently released third-quarter update.[4] We now expect revenues to grow by 1.1 per cent in fiscal 2019–20, which is about $1.6 billion weaker than forecast in the update. And while we expect revenues to rebound in fiscal 2020–21, revenue growth will be subdued due to overall continued weakness in world oil prices. Over the next three years, revenue growth should average just 3.7 per cent, which is 3.5 percentage points lower than what was projected in the third-quarter update. (See Chart 3.)

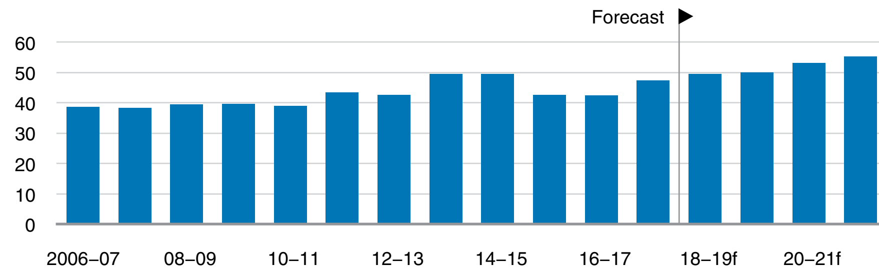
3 The Canadian Press, "Alberta Investing $3.7B to Move Oil by Rail, Leasing Cars," *Global News*, February 19, 2019. https://globalnews.ca/news/4976233/alberta-investing-3-7b-to-move-oil-by-rail-leasing-car/.

4 Government of Alberta, *2018–19 Third Quarter Fiscal Update and Economic Statement* (Edmonton: Treasury Board and Finance, Government of Alberta, 2019), accessed February 28, 2019, https://www.alberta.ca/budget-documents.aspx.

Chart 3

Alberta Revenue Rebound Slowed by WTI–WCS Wedge

($ billions)



f = forecast
Sources: The Conference Board of Canada; Alberta Ministry of Treasury Board and Finance; Statistics Canada.

A major concern contained in the update was the government's reliance on risky royalty revenues. As a share of total revenues, royalties were forecast to increase from a current level of about 11 per cent to over 18 per cent by 2023–24. There is always considerable uncertainty in projecting resource royalties. If oil prices end up being lower than expected, it will have a significant impact on the province's finances through its impact on royalties and corporate income taxes. In its latest budget, the government estimates that for each US$1-a-barrel decline in the price that Alberta producers earn for their oil, revenues will fall by $265 million. This presents a major downside risk going forward for the province.

A small, but symbolically important, fiscal measure introduced by the government in 2017 is the provincial carbon levy. The province expects the carbon tax to be an increasingly important source of revenue as the rate rises. Currently, the tax is revenue neutral. But by 2021, the additional revenues raised by the tax will be used to fund government services.[5] New sources of revenue such as the carbon tax are an important source of revenue for the provincial government because

5 Geoffrey Morgan, "Alberta to Use Carbon Tax Money to Balance Its Books, Expects Surplus by 2023," March 22, 2018, https://business.financialpost.com/news/economy/alberta-to-use-carbon-tax-money-to-balance-its-books-expects-surplus-by-2023.

they are more predictable than the revenue that comes from volatile commodities such as oil. Our view is that Alberta should consider other additional sources of reliable revenue. In particular, we continue to believe that Alberta would be well served by implementing a sales tax. While political realities make this unlikely, it is difficult for Alberta to justify being the only province without a sales tax while, at the same time, running the largest budget deficits on a per capita basis in the country.

Plan to Restrain Program Spending Is Ambitious

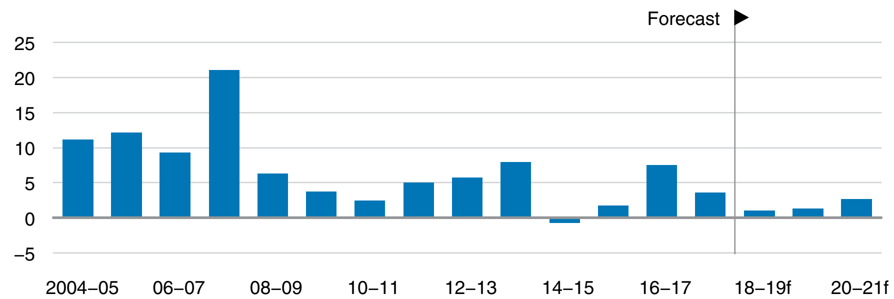
Budget 2018 included a plan to hold total expenditures (which is the sum of program spending and debt repayment charges) to an average annual growth rate of 2.7 per cent over fiscal years 2018–19 to 2021–22. (See Chart 4.) This means that the government will have to hold spending essentially flat in real terms, as inflation and increased interest rates will easily eat up the spending target set out in Budget 2018. The province plans to reach this target by restraining spending on the biggest-ticket items—health care and education. We think the plan to hold education and health care spending growth below demand over a prolonged period could prove challenging and presents a risk that the province could underperform fiscal expectations, especially given the aging of its population.[6] Additionally, the government's announcement that it will spend $3.7 billion on rail cars will make finding the planned savings even more challenging over the near term.[7] Indeed, the provincial government's recently released third-quarter update outlined a large uptick in non-operating expenditures, which is likely due to the rail

6 For the purposes of our forecast, we are using Budget 2018's program spending targets—including targets for health care, education, and other program spending—until 2020–21. However, for 2021–22, Budget 2018 provided only a total expenditure target. As a result, we use this expenditure target of 4 per cent as our target for total program spending, and then subsequently use our own forecasts for health care and education, with spending reductions occurring in "other program spending" in order to reach this target.

7 This purchase was not included in Budget 2018's spending targets and, as such, we have included it only as a risk until further details are released.

car purchase. However, since no further details were given, we will have to wait until the government releases its pre-election budget for more details.

Chart 4
In the Midst of Spending Restraint …
(total program spending, percentage change)



f = forecast
Sources: The Conference Board of Canada; Alberta Ministry of Treasury Board and Finance; Statistics Canada.

The government has budgeted for average annual growth of about 3.7 per cent in health care expenditures between 2018–19 and 2020–21—an ambitious target given that health care expenditures grew by an annual average of 5.6 per cent over the past 10 years. However, projections from The Conference Board of Canada's demographic model of heath care spending indicate that it will need to increase by an annual average of 5.1 per cent over the forecast period to meet the demands of a growing, and aging, population. If spending were to fall in line with our health care model projections between 2019–20 and 2020–21, the average annual difference between our model and Alberta's Budget 2018 would be nearly $650 million.

The latest provincial budget also plans to restrain education spending growth to 3.0 per cent per year over 2018–19 to 2020–21. As with health care expenditures, there will be challenges achieving that goal. Given

Alberta's strong population growth, we estimate that education spending must increase at an average annual rate of around 3.7 per cent per year just to keep real spending per student flat.

Lack of Credible Plan to Balance Budget Means Province's Debt Outlook Is Negative

The government's current plan is to continue shrinking the deficit every year until the budget balances in 2023–24. In our assessment, this is unlikely to happen. We expect the deficit to grow to $7.8 billion this upcoming fiscal year and essentially remain flat until the end of the forecast period.

Our deficit projections differ from the government's due to our more pessimistic outlook for provincial revenues, which is largely due to our weaker outlook for royalty revenues. Though the government has taken some steps to diversify its revenue base by raising some income taxes and introducing a carbon levy, Alberta remains highly vulnerable to commodity price swings. In its third-quarter update, the provincial government assumed that royalties will make up a growing share of total revenues, increasing from around 11 per cent share to over 18 per cent by 2023–24.

Ongoing deficits over the medium term will continue to add to the provincial debt, and the situation could deteriorate even further, given the risk of credit downgrades. The province received downgrades from multiple ratings agencies in 2017 but managed to avoid any further downgrades in 2018. However, two of the four major credit rating agencies believe that Alberta is a risk, due largely to its continued deficits.[8] The provincial government will want to seriously consider the implications of this, as any future credit downgrade would increase interest costs on the existing debt.

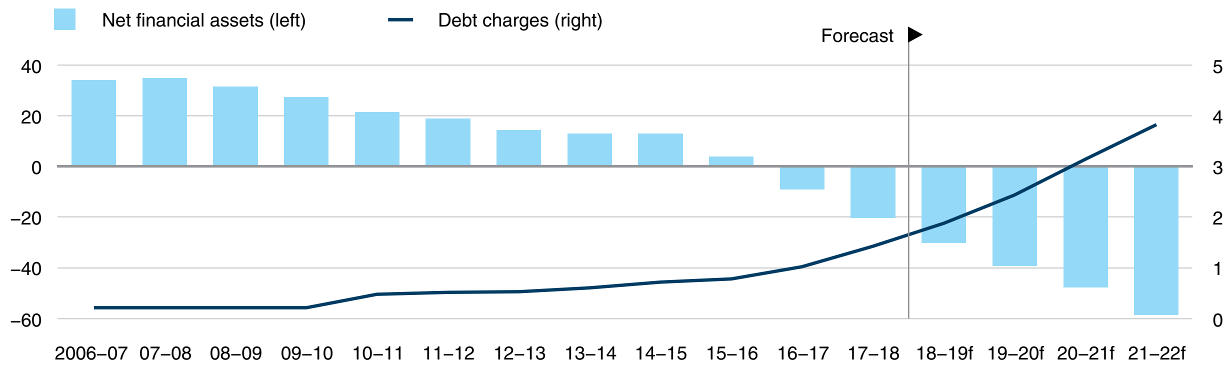
8 Government of Alberta, "Investor Relations," accessed February 21, 2019, https://www.alberta.ca/investor-relations.aspx.

The good news is that Alberta's debt remains much lower than that of its provincial peers. But that could be in jeopardy over the medium term if the deficits persist, as we think they will. Albertans have taken pride over the past few decades in the fact that the province's total debt has remained well below the levels in the other provinces. However, the situation has changed dramatically, and that is a cause of concern for Albertans. Overall, we expect net debt to nearly triple between 2017–18 and 2021–22, growing from just over $20.2 billion to $58.6 billion. (See Chart 5.)

Chart 5

… Alberta's Net Financial Assets Become Net Debt

(net financial assets, $ billions; debt charges, $ billions)



f = forecast
Sources: The Conference Board of Canada; Alberta Ministry of Treasury Board and Finance; Statistics Canada.

Provincial Comparisons

After years of riding high oil prices to prosperity, Alberta finds itself in a new position. It had the highest deficit-to-GDP ratio in the country last year at 2.6 per cent, and we expect it to continue to hold this dubious distinction in each of the next three fiscal years.

There are two main reasons why Alberta will have difficulty balancing its books in a timely fashion. First, taxation in the province is the lowest in Canada—the province has no sales tax and nearly flat personal income taxes.[9] Alberta's tax revenues will be approximately 6.8 per cent of GDP this fiscal year. By contrast, its neighbours will pull in much higher levels of tax revenues as a share of GDP—8.8 per cent in Saskatchewan and 10.4 per cent in British Columbia. Not coincidentally, Saskatchewan appears to be on a sustainable path to balancing its budget and British Columbia will continue to run a surplus. The Alberta Treasury is overly dependent on oil royalties to fund its operating expenses, and when commodity prices are low, Alberta simply cannot fund its programs without borrowing money.

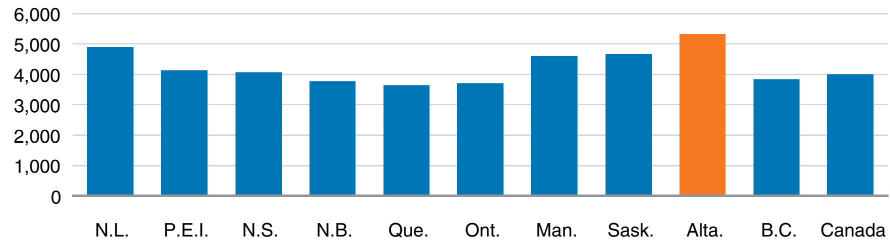
Revenues are not the only reason for Alberta's continued deficits. Alberta spends far more than other provinces on health care. Health expenditures on a per capita, age-adjusted basis were $5,312 in 2016—the highest in Canada and 33 per cent above the national average.[10] (See Chart 6.) This high level of spending is in spite of Alberta having a younger population than most of the rest of the country.[11] Last fiscal year, 45 cents of every revenue dollar taken in by the province was poured into health care spending. Given the province's high level of spending in this area and the fact that demand for health services will continue to grow, containing growth in health spending will be key to reining in future deficits.

9 Although one of the first tasks of the new NDP government was to make the personal income tax rate more progressive, it achieved this by introducing four new brackets for income earners over $125,000, leaving tax rates flat for all but a small fraction of the highest earners.

10 Canadian Institute for Health Information, "National Health Expenditure Trends, 1975 to 2016: Data Tables, Table B.4.6 Provincial/Territorial Government Sector Health Expenditure Standardized by Age and Sex and the Percentage Difference Between Standardized and Actual Expenditure, by Province/Territory and Canada, 1998 to 2014—Current Dollars," https://www.cihi.ca/en/national-health-expenditure-trends (accessed July 13, 2017).

11 Statistics Canada, "Annual Demographic Estimates: Canada, Provinces, and Territories—Section 2: Population by Age and Sex," last modified September 28, 2016, https://www150.statcan.gc.ca/n1/pub/91-215-x/2016000/part-partie2-eng.htm.

Chart 6
Provincial/Territorial Government Sector Per Capita Health Expenditure (Standardized by Age and Sex)
($ per capita)



Sources: Canadian Institute for Health Information, National Health Expenditure Trends 1975 to 2018, "Table B.4.6"; The Conference Board of Canada.

Final Thoughts

The crisis in Alberta that began near the end of 2018 with the plunge in WCS prices forced the government to act, and the quick response—in the form of production cuts—averted what could have been a much more dire outcome. It is likely that the damage to the province has been contained, as the WCS price rebounded in the early part of 2019. However, the oil price collapse of last autumn and the subsequent government response emphasizes how reliant the provincial government is on royalty revenues to fund its operations. Even with the government action on oil production and the resulting rise in revenues, the province still finds itself in a significant deficit position, and this will continue over the medium term.

Alberta had been running a deficit well before the surge in the WTI–WCS differential wedge and even prior to the commodities price crash of 2014. This indicates that the province's deficit is driven by structural factors in addition to the volatility in oil prices. On the expenditure side, Alberta has some of the highest per capita program spending, especially on health care, in the country. On the revenue side, the treasury remains highly dependent on volatile resource royalties. In a world where oil prices are likely to remain low, the province must address both revenues and

expenses if it is to bring Alberta's finances back to balance and ensure their sustainability. We continue to believe that the government should consider new sources of revenue, including a sales tax, to bring its earnings into line with its spending.

Table 1

Key Economic Indicators

(forecast completed: February 5, 2019)

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21	2021–22
Real GDP (by fiscal year, 2007 $ millions)	350,049	331,509	325,194	339,012	346,110	352,598	363,298	368,864
	4.4	*–5.3*	*–1.9*	*4.2*	*2.1*	*1.9*	*3.0*	*1.5*
GDP (by fiscal year, $ millions)	368,091	313,544	308,140	335,414	340,923	348,145	370,592	384,181
	4.1	*–14.8*	*–1.7*	*8.9*	*1.6*	*2.1*	*6.4*	*3.7*
Employment (000s)	2,286	2,296	2,264	2,300	2,339	2,364	2,404	2,450
	2.1	*0.4*	*–1.4*	*1.6*	*1.7*	*1.1*	*1.7*	*1.9*
Unemployment rate (per cent)	4.8	6.6	8.4	7.4	6.6	6.6	6.5	6.3
Total revenue ($ millions)	49,481	42,619	42,293	47,349	49,473	49,997	52,986	55,119
	0.1	*–13.9*	*–0.8*	*12.0*	*4.5*	*1.1*	*6.0*	*4.0*
Own-source revenue ($ millions)	43,499	35,477	34,314	39,743	41,228	41,527	44,341	46,136
	2.7	*–18.4*	*–3.3*	*15.8*	*3.7*	*0.7*	*6.8*	*4.0*
Federal transfers ($ millions)	5,982	7,142	7,979	7,606	8,245	8,470	8,645	8,983
	–15.3	*19.4*	*11.7*	*–4.7*	*8.4*	*2.7*	*2.1*	*3.9*
Total program spending ($ millions)	48,048	48,915	52,602	54,491	55,053	55,759	57,246	59,523
	–0.7	*1.8*	*7.5*	*3.6*	*1.0*	*1.3*	*2.7*	*4.0*
Health spending ($ millions)	19,366	20,115	20,687	21,239	22,099	22,782	23,478	24,673
	7.8	*3.9*	*2.8*	*2.7*	*4.0*	*3.1*	*3.1*	*5.1*
Education spending ($ millions)	13,103	13,673	14,110	14,471	14,633	15,038	15,478	15,975
	2.5	*4.4*	*3.2*	*2.6*	*1.1*	*2.8*	*2.9*	*3.2*
Other program spending ($ millions)	15,579	15,127	17,805	18,781	18,321	18,939	19,529	20,207
	–11.7	*–2.9*	*17.7*	*5.5*	*–2.4*	*3.4*	*3.1*	*3.5*
Required savings to achieve program spending target ($ millions)	0	0	0	0	0	1,000	1,239	1,332
Share of program spending	0.0	0.0	0.0	0.0	0.0	1.8	2.2	2.2
Debt charges ($ millions)	722	776	1,018	1,420	1,874	2,432	3,142	3,820
	20.1	*7.5*	*31.2*	*39.5*	*32.0*	*29.8*	*29.2*	*21.6*
Balance ($ millions)	1,115	–6,442	–10,784	–7,969	–7,144	–7,828	–7,037	–7,859
	–469.2	*–677.8*	*67.4*	*–26.1*	*–10.4*	*9.6*	*–10.1*	*11.7*
Net debt ($ millions)	13,054	3,881	–8,901	–20,269	–30,142	–39,323	–47,773	–58,662
	0.2	*–70.3*	*–329.3*	*127.7*	*48.7*	*30.5*	*21.5*	*22.8*

Shaded area represents forecast data; *italics indicate percentage change.*

Sources: The Conference Board of Canada; Alberta Ministry of Treasury Board and Finance; Statistics Canada.

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