November 14, 2017

Newfoundland and Labrador's Fiscal 2017–18 Update ...Staying the Course

Budget Balances

FY17 Final: -$1.148bn (-3.7% of GDP)
FY18 Budget: -$778mn (-2.5% of GDP) **Update: -$852mn (-2.7% of GDP)**

FY19b: -$644mn (-2.0% of GDP) FY20b: -$342mn (-1.0% of GDP)
FY21b: -$324mn (-0.9% of GDP) FY22b: -$72mn (-0.2% of GDP)
FY23b: +$24mn (+0.1% of GDP)

Borrowing

FY17 Final: $2.9bn
FY18 Budget: $0.4bn **Update: $0.7bn**

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REVENUE AND EXPENDITURE DETAILS

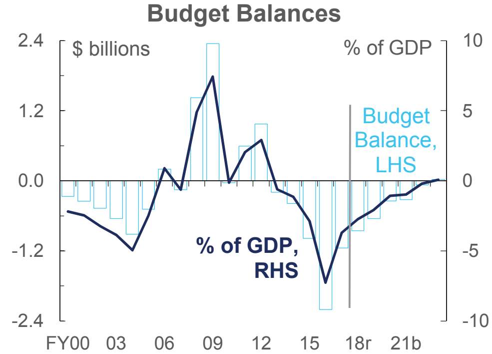
The projected $75 million widening of the deficit for fiscal 2017–18 (FY18) still leaves the shortfall well below 3.0% of GDP (side chart), maintaining the trend of substantial fiscal repair. Total revenues now are expected to be $79 million weaker than *Budget,* representing an annual rise of 1.4% not 2.5% over FY17 (p.2, right table).

In addition to softer personal income tax revenues, offshore royalties are projected to be $147 million less than *Budget,* despite largely avoiding the 7.8% decline in oil production assumed in the *Budget* for calendar 2017. The Brent oil price for FY18, expected last spring to average US$56/barrel, is now forecast to average US$53.50[1]. As well, the Canadian dollar vis-à-vis the US dollar is higher than expected and prior period adjustments are eroding revenues. Upward revisions to the Corporate Income and Mining Taxes are providing only a partial offset.

Encouraging are slightly stronger performances across a range of economic indicators in 2017 (p.2, left table), though the revised real GDP decline of 3.2% for this year is still steep, reflecting investment activity winding down on major resource projects. In 2017, the Province estimates that construction-related investment, involving relatively high-paying jobs, will fall back to levels not seen since 2012. The ramp-up of production at Hebron, the fourth offshore oil field, is expected to power a 1.5% output gain in 2018. But in 2020 and 2021, further real GDP declines of 1.1% and 2.3% are forecast by the Province.

With revenue options limited, tight expenditure management continues to accomplish the projected 2.3% decline in FY18. At mid-year, core government spending is expected to be $22 million below *Budget,* but outlays by Agencies, Boards and Commissions is $18 million ahead of plan and their spending is being reviewed.

Newfoundland and Labrador's Budget Balances



Sources:NL Finance; Statistics Canada; nomnial GDP forecasts: Scotiabank Economics.

[1] The spring *Budget* indicated that for FY18, royalties will rise by $23.4 million for each US$1/ barrel increase and fall by almost $22 million for a US$1 decline. A 1¢(US) gain in the Canadian dollar will trim royalties by $16.2 million and a 1¢(US) drop will add nearly $18 million.

Newfoundland and Labrador's Economic Assumptions
annual % change except where noted

	Calendar 2017	
	Budget	Update
Real GDP	-3.8	-3.2
Nominal GDP	1.8	3.6
Consumer Price Index	2.9	2.6
Population	-0.5	-0.3
Employment	-1.9	-4.1
Participation Rate, %	60.0	59.3
Unemployment Rate, %	13.9	15.1
Household Income	-0.3	1.8
Retail Sales	-0.2	1.0
Housing Starts, units	1,350	1,158
Capital Investment	-7.8	-10.6

Source: Newfoundland and Labrador Finance.

Newfoundland and Labrador's Summary Fiscal Update
$ billions except where noted

	FY17	FY18	
	Final	Budget	Update
Oil Royalties	983	882	735
Gov't Bus. Ent Net Income	451	441	491
Other Own-Source Rev.&Fed. Transfers	5,723	6,016	6,035
Total Revenues	**7,157**	**7,339**	**7,260**
% ch.	*19.7*	*2.5*	*1.4*
Core Government	-	3,809	3,787
Agencies, Boards and Commissions	-	4,308	4,326
Total Expenditures	**8,305**	**8,117**	**8,113**
% ch.	*1.5*	*-2.3*	*-2.3*
% of GDP	*26.7*	*27.0*	*27.0*
Deficit	**-1,148**	**-778**	**-852**
% of GDP	*-3.7*	*-2.6*	*-2.8*

Source: Newfoundland and Labrador Finance.

Aligned with its strategy, *The Way Forward,* economic diversification efforts continue with measures such as increased Crown land for agriculture, geoscience support for mining and a target of scaling up 20 technology firms annually as its *Business Innovation Agenda* is rolled out. New activity is emerging in the mining sector—a fluorspar mine and mill are opening this year, an expansion of the Labrador City iron ore complex is under way and a resumption of iron ore production is planned at Wabush. However, construction of an underground mine at Voisey's Bay has halted subject to a global review of the company's base metal operations.

The $0.3 billion rise in FY18 borrowing requirements in part reflects a $137 million increase in the government's investment in Nalcor Energy reflecting the further rise in the capital cost estimates for the Muskrat Falls hydroelectricity project in June 2017 (see text box, p.3). Positive income, however, is being realized on the Province's equity investment in offshore oil.

OUTLOOK

Newfoundland and Labrador anticipated both good news and setbacks along its deficit elimination path. In the critical offshore oil sector, several major petroleum corporations are pursuing sizeable exploration programs over the next decade and outstanding work commitments total $2.9 billion. Development of the $2.2 billion West White Rose project is expected to resume late this year, with first oil expected in 2022. Conversely, to date, the auction this Fall of offshore parcels has been less buoyant than in recent years. A bid of $15 million was received for one offshore parcel, and the bid process for ten offshore parcels in the Labrador South Region will only close 120 days after the completion of the *Labrador Strategic Assessment,* currently under way.

Reducing red ink with less than a steady economic expansion was expected to be difficult. In this *Update,* the government again admits the challenges, alongside a commitment to continue to adjust their plan as their economic and fiscal challenges evolve.

The Muskrat Falls Hydroelectricity Project, September 30, 2017

- The estimated capital cost of the Muskrat Falls 824MW hydroelectricity station and the two related transmission projects is unchanged from the June 2017 announcement (table below). At its peak in July 2017, 85% of the project workforce were residents, numbering about 5,300. As of September 30, total incurred costs for the project are $7.6 billion; total committed costs are $8.8 billion. All major contracts for the project have been awarded and most of the major equipment manufacturing is substantially complete.

- In the “all-in” cost of the project at in-service, the “Financing and Other Costs” component includes pre-funded financing reserve accounts (that will only be refunded during the debt repayment period), pre-commissioning costs and financial closing related costs.

- On the $7.9 billion borrowed that has been guaranteed by the Government of Canada through two separate Federal Loan Guarantees, the average effective interest rate is 3.8% on the $5.0 billion tranche and 2.9% for the $2.9 billion portion.

- The Labrador Transmission Assets achieved substantial completion in July 2017, and as of September, are expected to be ready for power transmission in February 2018. The Labrador Island Transmission Link is expected to be ready for power transmission in mid-2018. This should allow access to their portion of the Upper Churchill Falls power next winter, reducing the fuel costs associated with the operation of Newfoundland’s 490MW Holyrood thermal generating station on the Island.

- For the Muskrat Falls hydroelectricity station, first power is expected in late 2019 with full power by August 2020. Commissioning of the full project is anticipated in September 2020.

- Newfoundland and Labrador Hydro submitted to the Public Utilities Commission a General Rate Application in July 2017 proposing average power rate increases for 2018 and 2019 of: 6.6% and 6.4% for most residential customers on the Island; 4.3% and 8.2% for interconnected system customers in Labrador; and 6.2% and 7.0% for Island industrial customers. This follows the power rate hike on July 1, 2017, averaging 8.1% for residential customers, for example, that resulted from a final ruling on the utility’s 2013 General Rate application.

- In June 2017, Nalcor also indicated that base operating and maintenance costs estimated in 2012 at $34 million annually for start-up in 2018 were re-estimated this year at $109 million for the proposed start-up in 2020 (including $9 million for environmental monitoring).

The Muskrat Falls Hydroelectricity Project — Selected Indicators
$ billions except where noted

	In-Service Capital Cost (June 2017)			**Oversight Committee** (Sept.30,2017)	
	Sanction 2012	**June 2016**	**June 2017**	**Costs Incurred**	**% Completed**
Labrador Transmission Assets	0.7	0.9	0.9	0.8	92.5
Labrador Island Transmission Link	2.6	3.4	3.7	3.2	98.5
Muskrat Falls Generating Station	2.9	4.8	5.5	3.6	75.3
Financing & Other Costs	1.2	2.3	2.6	-	-
Total Project	**7.4**	**11.4**	**12.7**	**7.6**	**85.1**

Source: Capital Costs: Nalcor, June 2017; Costs Incurred & % Completed: Muskrat Falls Project Oversight Committee, November 2017.