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Using extra revenue (& some marginal debt) to finance key priorities

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Highlights

- A surplus of $374 million is now projected for 2018-19, an improvement vs the $219 million surplus forecast in Budget 2018 but down from the $1.35 billion surplus estimated in Q2. Among other things, the smaller surplus vs Q2 captures: new legislative spending; negative adjustments at BC Hydro and ICBC; eliminating interest on student loans; lower taxation revenue.
- With barely a month to go in the 2018-19 fiscal year, there's a residual forecast allowance of $500 million and $550 million of spending contingencies. So the final 2018-19 budget balance will likely look quite a bit better than this latest estimate.
- BC plans for a surplus of $274 million in 2019-20. That's *after* a $500 million forecast allowance and a contingencies vote of $750 million. Additional contingencies have been earmarked to cover costs tied to future collective bargaining agreements. There's also a sub-consensus economic growth forecast and relatively conservative assumptions around natural gas prices.
- The budget is based on 2.4% real GDP growth in 2019, followed by 2.3% in 2020. The respective assumptions for nominal GDP growth over that two-year period are 4.4% and 4.3%.
- The medium-term fiscal plan anticipates a surplus of $287 million in 2020-21 and an even larger $585 million surplus by 2021-22. Those budgetary figures are after forecast allowances and contingencies.
- Priority investments were made along three core streams: "making life affordable", "enhancing services that people count on" and "building a strong and sustainable economy that works for everyone". A new CleanBC plan, which aims to reduce emissions and support a low-carbon and innovative economy, was developed in partnership with the BC Greens, on whose support the minority NDP government has depended.
- Medical Services Plan premiums will be fully phased out by 2020, fulfilling a key policy commitment. In an historic move, seven per cent of gaming income will be shared with First Nations. There were no new measures that increased provincial government revenues. Property transfer tax revenue looks to be flat over the full three-year fiscal plan.
- BC Hydro dividends are being phased out to stabilize rate increases and strengthen the capital structure. As for ICBC, a series of reforms aim to substantially trim the net loss in 2019-20, paving the way for positive operating results starting in 2020-21.
- Total taxpayer-supported debt looks to be ending 2018-19 at just under $44 billion or 14.9% of GDP. Operating debt has been eliminated as of 2018-19.
- Taxpayer-supported debt is projected to grow $10 billion over three years, with the corresponding debt-to-GDP ratio edging up to 15.0% in 2019-20 and to 16.1% by 2021-22. Still, the revised profile for the debt burden is better than prior budget guidance.
- In the outgoing fiscal year, BC met the majority of a $6.8 billion gross borrowing requirement via internal financing sources and/or short-term markets. That meant just $3 billion of gross bond issuance for 2018-19, all of it conducted in the C$ public market.
- The budget envisions ~$7.5 billion of gross borrowing in 2019-20, followed by more than $8 billion by 2020-21 and $8.6 billion by 2021-22 (i.e., more than $24 billion over three years). These gross borrowing figures are driven primarily by new taxpayer-supported capital spending, along with new investments by self-supported entities, notably BC Hydro.
- Official borrowing requirements include forecast allowances and other layers of prudence. Moreover, it remains possible that some of the assumed borrowing could be met via internal financing sources or through marginal issuance of short-term debt.
- BC expects to "readily manage these requirements by accessing its established domestic and international investor bases". Strong credit ratings, solid fiscal management and secondary market liquidity have traditionally attracted a diverse investor base. Having limited issuance in recent years, the broader fixed income investor base looks to have sufficient room to digest net supply.
- Overall, while BC is taking on marginal leverage at a mature stage of the economic cycle, it's doing so from a position of fiscal strength and does not look to be seriously compromising debt affordability metrics.
- This was the second full/comprehensive budget from the BC NDP, which came to power in mid-2017. With 41 of 87 seats, the NDP are currently governing in a minority legislature, having secured passage of key legislation via a confidence and supply agreement with the BC Green Party (3 members currently).

2018-19: Above-plan revenue allocated to supplementary spending priorities

In 2018-19, British Columbia funneled some windfall revenue (and there was a fair bit of it) into priority spending areas. At the same time, the province beat its original forecast for the budget balance, staying in the black for a sixth straight fiscal year with a lower-than-planned debt burden.

For the outgoing fiscal year, top-line revenue surged more than $2.4 billion or 4.5% above plan. Netting off above-plan spending ($2.1 billion or 4% higher than budget), the revised budget surplus *after the forecast allowance* is now estimated at $374 million (equivalent to 0.13% of GDP or 0.7% or revenue). That's an improvement vs the $219 million surplus originally projected a year ago in Budget 2018.

Nonetheless, the latest estimate of the surplus is a fair bit lighter than what had been telegraphed in a late-November Q2 update. Recall that BC's second quarter report pegged the 2018-19 budget surplus at $1.35 billion, and that was after setting aside quite a hefty forecast allowance of $950 million. In reconciling today's smaller surplus relative to Q2, there are a few items of note: new legislative spending of $375 million, to be approved via Supplementary Estimates and covering a range of initiatives (everything from high-speed internet, research grants, northern infrastructure, child care fee reductions to local government grants); negative adjustments for key Crowns, including a one-time write-off in BC Hydro's deferred regulatory account (a net hit of $186 million for 2018-19 after controlling for a $950 million negative adjustment already booked in 2017-18, adding up to $1,136 million in total) and a larger/sizeable net loss at the Insurance Corporation of British Columbia (discussed below); eliminating interest on student loans; lower taxation revenue.

It's important to note that there's still $500 million sitting in a forecast allowance—a pretty sizeable residual buffer given that there's barely a month left to go in the fiscal year. Moreover, an additional $550 million of spending contingencies are still set aside. So don't be at all surprised if, as in years' past, BC's budget balance for 2018-19 ends up looking quite a bit better in the final analysis than this latest estimate.

By way of an inter-provincial comparison, BC now has a bit more company when it comes to balancing the budget. Based on the latest available estimates, half of Canada's ten provinces expect to be balanced in 2018-19. Note, however, that no other province can boast as long a continuous streak of surpluses as BC, which got in the black back in 2013-14. BC is also alone in running a *cumulative* surplus over the past 10 years (i.e., covering the complete post-crisis period from 2009-10 to 2018-19).

Staying in balance through 2021-22

Budget 2019 would see BC's surplus era extending at least until 2021-22. For the coming fiscal year, 2019-20, a surplus of $274 million has been forecast, equivalent to <0.1% of GDP or 0.5% of revenue. That's *after* a $500 million forecast allowance, which represents but a single layer of prudence built into the fiscal framework (albeit the most conspicuous one). For context, $500 million represents 0.85% of total projected revenue for 2019-20, and based on official/published fiscal sensitivities, would protect against as much as a 2%-pt hit to the level of nominal GDP. (All else equal, each 1%-pt hit to nominal growth is thought to cost the government $150-250 million/year.)

The budget envisions 4.3% total revenue growth in the coming fiscal year, held back by some key tax relief initiatives (discussed below) and consistent with an underlying economic forecast that incorporates a housing cool down but is nonetheless characterized by relatively healthy growth overall. Indeed, real GDP growth assumptions for both 2019 and 2020 have been lifted relative to earlier guidance, to 2.4% and 2.3% respectively, owing to reduced Canada-US trade risks and the lift provided by LNG development (where a final investment decision on a mega-project in Kitimat had previously been announced). As always, assumed rates of real GDP growth have been set below the private sector consensus each year of the planning horizon (by 0.1-0.3 percentage points), representing another layer of fiscal prudence. Nominal GDP growth—generally considered the better proxy for own-source revenue—is seen running at an annual rate of 4.3-4.4% through 2020.

Fiscal prudence also takes the form of a regular contingencies vote, set at $750 million for 2019-20 (and $400 million/year thereafter). That's a pretty significant buffer, one which could protect against unforeseen spending pressures should they arise and/or fund priority investments. Additional contingencies have also been earmarked to cover anticipated costs tied to future collective bargaining agreements, with costs linked to all ratified agreements already covered in base budgets.

For completeness, there's also relatively conservative assumptions around natural gas prices, although to be fair, natural gas royalties don't currently exert a lot of influence on provincial revenue. The budget forecasts $275 million of natural gas royalties for 2019-20 on an average gas price of C$0.72/GJ (plant inlet). That's less than half of one per cent of BC's full-year revenue and represents only a quarter of anticipated forestry revenue, even allowing for pressure here due to lower lumber prices/stumpage rates and reduced volumes.

The medium-term fiscal plan anticipates a surplus of $287 million in 2020-21 and an even larger $585 million surplus by 2021-22. Those budgetary figures are *after* the forecast allowance, which has been set at $300 million for both years. All told, we're talking about more than $3 billion in aggregate/combined budget surpluses *before* forecast allowances over the entire four year period covering 2018-19 to 2021-22. That's an improvement relative to a year ago, when the corresponding four-year tally (at that point covering the 2017-18 to 2020-21 period) added up to an underlying surplus of <$2.5 billion.

Priority investments: There are a few

Generally speaking, much of the extra revenue spun off from a still-buoyant economy is being spent/invested. Consistent with this government's earlier actions and a recent Throne Speech, the budget's priority investments were along three core streams: "making life affordable", "enhancing services that people count on" and "building a strong and sustainable economy that works for everyone".

The budget addresses "affordability" through the full elimination of Medical Services Plan (MSP) premiums on January 1, 2020, extending relief that started last year with a 50% premium cut and fulfilling a key policy commitment for this minority NDP government.

There was a significant $375 million investment over two years in a new BC Child Opportunity Benefit (effective October 1, 2020, enriching benefits vs the prior program), as well as $85 million over three years in family support. As noted, students will benefit from the elimination of interest on all BC student loans, effective immediately and translating into costing $93 million over three years. Lastly, a $307 million increase in Income and Disability Assistance Rates over three years was presented.

On the "service" front, $965 million will be invested over three years in total health spending, including $819 million to improve access to health care services. This also comprises a new investment of $42 million to cover more drug options as well as a $74 million investment in mental health care/addiction services for children and youth. There was $550 million for K-12 facilities over three years, contributing to the creation of (among other things) 5,500 new student spaces.

Similarly, investments targeting a "strong and sustainable economy" included $679 million over three years for CleanBC initiatives. This program was created in partnership with the BC Green Party, on whose support the NDP depend in this, a minority legislature. It's focused on clean transportation, energy efficient homes/buildings, waste diversion, etc. Of note, Budget 2019 increases the Climate Action tax credit each of the next three years, in line with carbon tax increases. (Effective July 1, 2019, the maximum tax credit will be increased by 14%. Meanwhile, BC's carbon tax rate is set to hit $50 per tonne by 2021-22, reaching that threshold one year ahead of the federal government's mandated date.) An incremental investment of $111 million over three years will support wildfire management as well as $23 million for forest restoration and a forest carbon initiative. Notably, the government will invest $129 million over three years in communities, including $72 million in transportation projects. There was some additional funding for housing affordability and homelessness, adding to a large-scale investment undertaken last year.

Budget 2019 commits to a revenue-sharing agreement with First Nations, the value of which is pegged at $297 million over three years (and north of $3 billion over the coming 25 years). Specifically, and starting in 2019-20, "the government has committed to sharing seven per cent of its gaming income with BC First Nations".

There were no new measures that increased provincial government revenues. The province sees federal government action on immediate and full expensing of certain business investments as bolstering relative tax competitiveness, thereby spurring investment and job creation. Property transfer tax revenue, once a gusher for this province, is assumed to be flat over the full three-year fiscal plan given that a series of enacted measures have led to a moderation in resale activity. At $1.91 billion, property transfer taxes comprise just over 3% of total provincial revenue. That revenue share may not be enormous, but uncertainty around the BC housing market is nonetheless an acknowledged fiscal risk.

As required by regulation, the payment of BC Hydro dividends to the province are being phased out in order to stabilize rate increases and boost the capital structure. As for the Insurance Corporation of British Columbia (ICBC), the Crown Corporation is aligning with the province's headline priorities by delivering fair, affordable and sustainable rates and aiming to provide quality products and services. As largely telegraphed in last week's Speech from the Throne, significant changes in the organization will be implemented beginning April 1, 2019 to address losses of more than $2 billion in the last two years. All told, a series of measures should help the corporation return to financial sustainability, substantially trimming the net loss by 2019-20 and paving the way for operating surpluses starting in 2020-21.

Marginal debt/borrowing, but from a relatively low base

As per Budget 2019, BC's total taxpayer-supported debt looks to be ending 2018-19 at just under $44 billion or 14.9% of GDP. Operating debt has been eliminated as of 2018-19 and the budget is balanced as far as you can see. Nonetheless, there's a price tag attached to certain priority investments, and a record tax-supported capital spending plan ($20.1 billion over three years and up $4.3 billion vs Budget 2018) means incremental debt.

Taxpayer-supported debt is projected to grow by $2.4 billion in the coming fiscal year and by fully $10 billion over the complete three-year fiscal plan (i.e., reaching ~$54 billion by 2021-22). The corresponding taxpayer-supported debt-to-GDP ratio would edge a tiny bit higher in 2019-20, to 15.0%, moving up to 16.1% by 2021-22. Still, the new/revised profile for the debt ratio looks better than prior budget guidance. As for the interest bite on taxpayer-supported debt, it too would increase somewhat in each year of the fiscal plan, from 3.1% in 2018-19 to 3.7% in three years' time.

Whether it's the debt burden or the corresponding interest bite, these key financial ratios continue to look relatively healthy on an outright basis and are downright envious by Canadian provincial government standards. Thus, while BC is moving to take on some marginal leverage at a mature stage of the economic cycle to finance strategic/transformative capital works, it's doing so from a position of fiscal strength and does not look to be seriously compromising debt affordability metrics. It would seemingly be hard for rating agencies or bond investors to get too upset with the proposed budget balance and debt trajectory.

And just what can debt capital markets expected from highly-rated BC? Well, thinking back on 2018-19, the province materially undershot on gross bond issuance. Gross borrowing needs were revised down over the course of the year, owing to reduced capital spending and refinancing requirements. But BC also ended up satisfying $3.8 billion (i.e., the outright majority) of its $6.8 billion borrowing requirement via internal financing sources and/or short-term markets. That left just $3 billion of gross bond issuance for 2018-19, all of it conducted via benchmark 10- and 30-year Canadian dollar public issues.

As for 2019-20, the budget tentatively projects just under $7.5 billion in gross borrowing needs, with the marginal increase vs the prior year linked to capital investments. Gross borrowing needs are expected to breach $8 billion by 2020-21, growing further to $8.6 billion by 2021-22. Over the full three-year period, anticipated borrowing requirements add up to more than $24 billion, covering not only new taxpayer-supported capital works but also inclusive of self-supported net new investments (largely at BC Hydro for electrical generation, transmission and distribution) and nearly $5 billion of maturities requiring refinancing (i.e., not funded internally).

We'd stress that BC's gross borrowing figures include provisions for annual forecast allowances and other layers of prudence (as highlighted earlier). Again, this prudence is hardly trivial; for 2019-20, the forecast allowance and contingencies vote jointly add up to $1.25 billion, to say nothing of sub-consensus economic growth and resource price forecasts. Moreover, as we have seen more than a few times (including in the soon-to-be completed fiscal year), some of the province's assumed borrowing needs could be met via internal financing sources or through marginal issuance of short-term debt. Note that the starting cash position could well be stronger-than-expected, assuming the outgoing year's surplus ends up being a fair bit larger than currently estimated—a reasonable scenario in our opinion.

Regardless, BC sees itself in a position to "readily manage these requirements by accessing its established domestic and international investor bases". We tend to agree, with BC's strong credit ratings, demonstrated track record of solid fiscal management and relatively healthy secondary market liquidity (particularly in benchmark tenors) traditionally attracting a diverse investor base. Moreover, having held bond issuance in check over the past few years, the broader fixed income investor base looks to have sufficient room to digest marginal net debt issuance (which after maturities looks to average ~$4.8 billion/year through 2021-22).

British Columbia

$000,000	Update 2018/19	Budget 2019/20	Plan 2020/21	2021/22	Percentage change 2019/20	2020/21	2021/22
Taxation revenue	32,637	33,732	35,179	37,080	3.4%	4.3%	5.4%
Resource revenue	2,970	2,623	2,438	2,380	-11.7%	-7.1%	-2.4%
Other revenue	9,996	9,958	9,153	9,260	-0.4%	-8.1%	1.2%
Other federal transfers	9,062	9,423	9,765	10,118	4.0%	3.6%	3.6%
Commercial Crown corporation net income	1,971	3,311	3,503	3,620	68.0%	5.8%	3.3%
as of Insurance Corporation of British Columbia (ICBC)	*(1,180)*	*(50)*	*86*	*148*			
Total revenue	**56,636**	**59,047**	**60,038**	**62,458**	**4.3%**	**1.7%**	**4.0%**
Program spending	52,597	54,726	56,100	58,057	4.0%	2.5%	3.5%
Contingencies	550	750	400	400			
Debt servicing costs	2,615	2,797	2,951	3,116	7.0%	5.5%	5.6%
Total spending	**55,762**	**58,273**	**59,451**	**61,573**	**4.5%**	**2.0%**	**3.6%**
Forecast allowance	(500)	(500)	(300)	(300)			
Surplus	**374**	**274**	**287**	**585**			
Provincial Debt Changes							
Deficit (surplus) before forecast allowance	(874)	(774)	(587)	(885)			
Taxpayer-supported capital spending	4,771	6,340	6,837	6,911			
Self-supported capital investments	4,192	4,274	3,333	3,361			
Commercial Crown corp. retained earnings	(609)	1,907	866	875			
Amortization and other capital asset changes	(2,432)	(2,504)	(2,568)	(2,664)			
Other items	(2,051)	(4,611)	(2,955)	(2,881)			
Increase in total provincial debt	**2,997**	**4,632**	**5,111**	**4,717**			
Total provincial debt	**72,369**	**77,001**	**74,483**	**79,200**	**6.4%**	**-3.3%**	**6.3%**
Provincial government direct operating	**-**	**-**	**-**	**-**			
Other taxpayer-supported (mainly capital)	**43,957**	**46,384**	**50,454**	**53,986**	**5.5%**	**8.8%**	**7.0%**
Self-supported	**23,459**	**25,664**	**26,905**	**28,090**	**9.4%**	**4.8%**	**4.4%**
Forecast Allowance	**500**	**500**	**300**	**300**			
Total provincial debt / GDP	23.0%	23.5%	24.1%	24.6%			
Taxpayer-supported	14.9%	15.0%	15.7%	16.1%			
Capital Spending	**8,963**	**10,614**	**10,170**	**10,272**	**18.4%**	**-4.2%**	**1.0%**
Taxpayer-supported capital spending	4,771	6,340	6,837	6,911	32.9%	7.8%	1.1%
Self-supported	4,192	4,274	3,333	3,361	2.0%	-22.0%	0.8%
Provincial borrowing requirements	**6,838**	**7,454**	**8,079**	**8,596**			
Operatins deficit (surplus)	(374)	(274)	(287)	(585)			
Capital spending	8,963	10,614	10,170	10,272			
Refinancing requirements	2,710	2,112	2,014	2,347			
Other financing sources	(4,461)	(4,998)	(3,818)	(3,438)			
Large program expenses							
Education	14,273	14,609	14,781	14,918	2.4%	1.2%	0.9%
Health services	21,996	22,983	23,572	24,266	4.5%	2.6%	2.9%
Subtotal	43,992	45,966	47,144	48,532	4.5%	2.6%	2.9%
Other program expenses	8,605	8,760	8,956	9,525	1.8%	2.2%	6.4%
Total education / total expenses	25.6%	25.1%	24.9%	24.2%			
Health services / total expenses	39.4%	39.4%	39.6%	39.4%			
Debt servicing costs / total expenses	4.7%	4.8%	5.0%	5.1%			

Source: Budget documents, British Columbia Ministry of Finance

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