

ECONOMIC VIEWPOINT

Seven Burning Questions on Alberta's Finances What to Watch for in the Province's Mid-Year Fiscal Update

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HIGHLIGHTS

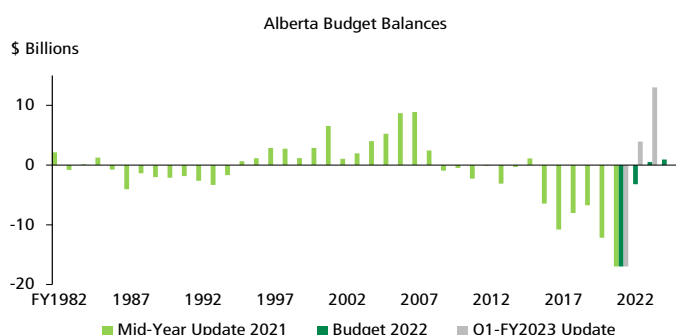
- ▶ With Alberta set to release its mid-year fiscal and economic update for 2022–2023 (FY2023) this month, we discuss seven questions that should be top of mind for investors and policymakers.
- ▶ Government fiscal sensitivities and the strength of WTI prices alone suggest an \$8-9 billion boost to the bottom line in FY2024 versus Budget 2022. That would build on the record budget surplus already forecast for this year.
- ▶ But downside risks are mounting. We estimate that light-heavy oil price discount effects plus potential new spending could shave close to \$4 billion off the bottom line next year.
- ▶ Other downside risks include capital project delays and the possibility of overestimating oil prices at a time of historic revenue sensitivity.
- ▶ Alberta's underlying revenue trajectory and any new spending measures will impact the funds available for ambitious plans to repay \$13.4 billion in debt this year.
- ▶ We suspect that markets have already priced in much of the underlying fiscal improvement, but Alberta's fiscal fundamentals are clearly strong, and that could drive lower market supply and support spreads against Government of Canada benchmarks in the coming years.

Introduction

Alberta's fiscal turnaround has been nothing short of remarkable. Just two years after the COVID-19 pandemic and the Saudi-Russian oil price war drove the deficit to record levels, the province balanced the books for the first time in seven years. It now forecasts a \$13.2 billion surplus in FY2023 (graph 1), which would represent the largest ever recorded by any Canadian province.

Momentum has persisted. WTI, which anchors Alberta fiscal forecasts, is still consistently trading above US\$80/barrel, drilling remains strong, and production is at record levels. Per fiscal sensitivities in Budget 2022, WTI would have to average about US\$65/barrel for the rest of FY2023 for the surplus to be less than \$10 billion (table 1 on page 2). Given structural supply-demand imbalances in global crude markets, few analysts expect that kind a drop, even with a recession looming.

GRAPH 1
From Record Deficit to Record Surplus in Just Two Years



Sources: Alberta Treasury Board and Finance and Desjardins, Economic Studies

TABLE 1
FY2023 WTI Price Arithmetic for Alberta's Budget

	WTI Price (USD/barrel)		Budget Balance (CAD millions)	
	Rest of Year	Full Fiscal Year	WTI Impact*	New Projection
Alberta Government Projection	—	92.50	—	13,160
WTI maintains YTD average	97.66	97.66	2,580	15,740
Desjardins Forecast, Oct. 2022	—	91.75	-375	12,785
Bloomberg Consensus, Nov. 15	—	95.51	1,505	14,665
80 USD/barrel rest of year	80.00	91.44	-528	12,632
65 USD/barrel rest of year	65.00	86.16	-3,168	9,992
8.23 USD/barrel rest of year	8.23	66.18	-13,160	0

* Assuming CAD 500 million per 1 USD/barrel WTI, per Alberta Budget 2022

Sources: Bloomberg, Alberta Treasury Board and Finance and Desjardins, Economic Studies

Activity is also strong outside the oil and gas sector. Alberta manufacturing is in a sweet spot as the Canadian dollar has recently decoupled from crude prices. Renewable energy projects are progressing. And people are flocking to Alberta, attracted by strong economic prospects and a relatively affordable housing market.

Still, downside risks are mounting, with implications for the province's public finances and issuance. With that in mind, we discuss seven key questions that should be a focus for investors and policymakers as Alberta updates its fiscal blueprint this month.

1. Just How High Can Natural Resource Revenues Go?

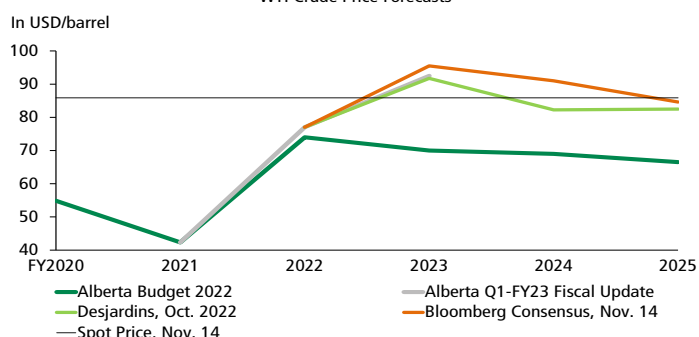
Surging resource revenues have dramatically improved Alberta's fiscal position over the last two years. The province's 2020 mid-year update, released at the height of the pandemic, projected non-renewable resource receipts of just \$1.7 billion in FY2021. A mere two years later, the Q1-FY2023 update forecast more than \$28 billion—double the prior record and \$14 billion more than projected just six months earlier.

Our back-of-the-envelope calculations suggest that higher oil prices could bolster projections for the bottom line by \$8-9 billion in FY2024. That uses Budget 2022 fiscal sensitivity estimates and assumes some easing from this year's peak, as witnessed after past windfalls and in line with consensus oil price forecasts (graph 2). Gains of that magnitude suggest we could see near-record natural resource receipts in FY2024, following a record in FY2023.

2. What Will WTI Forecasts Look Like?

Alberta's fiscal sensitivity to crude values is historically elevated, and that has major implications for oil price forecasts. To incite investment, Alberta's royalty regime charges lower rates to early-stage ventures and higher rates to projects that have recouped their initial capital costs. As of Budget 2022, the number of oil sands projects that had reached this high-rate "post-payout" status had increased significantly. Accordingly, the province

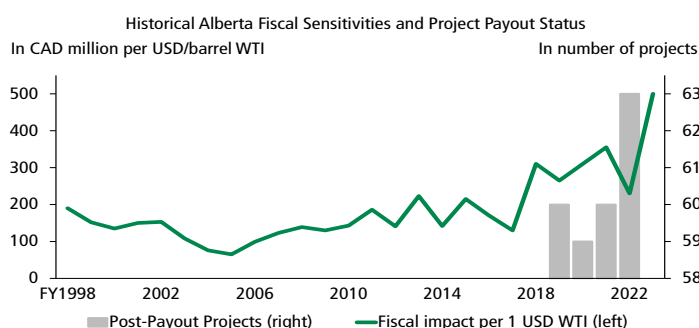
GRAPH 2
Budget 2022 Oil Price Projections Well Below Current Levels
WTI Crude Price Forecasts



Sources: Bloomberg, Alberta Finance and Treasury Board, and Desjardins, Economic Studies

estimated a record \$500 million net fiscal impact associated with every US\$1/barrel in WTI (graph 3). The FY2024 estimate—which will likely be published in Budget 2023—could conceivably be even higher as sky-high crude values likely boosted profitability over the last year.

GRAPH 3
Fiscal Upside from Surge in Post-Payout Oilsands Projects



Sources: Alberta Treasury Board and Finance and Desjardins, Economic Studies

With oil prices trading well above the latest government projections, high sensitivities present nothing but upside. But that also means there's higher-than-normal risk in overestimating crude values as projections are updated. Between this and an uncertain outlook for global petroleum demand as recession looms, look for outer-year WTI assumptions to be well below the average private-sector forecast.

3. How Wide a WCS-WTI Differential and for How Long?

There's also downside risk related to the Western Canada Select (WCS) benchmark's discount to WTI, which has hovered near US\$30/barrel for most of this month. Where WTI affects the royalty rate paid by producers, WCS more directly impacts the profits on which producers pay those rates. As several oil sands projects attained post-payout status last year, Budget 2022 estimated the fiscal sensitivity of the WCS-WTI discount at a

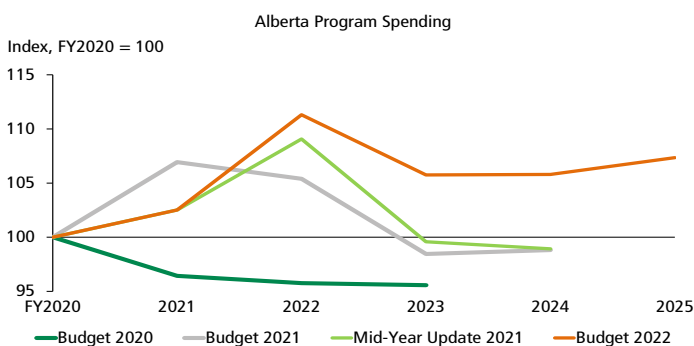
record \$460 million per US\$1/barrel. As with WTI, that figure could climb even higher beyond this year. Output set to come online in the next few years is more oriented towards heavy sour crude (whose prices track WCS) than in the past.

At Q1-FY2023, the government raised its forecast for the WCS-WTI discount by almost US\$5/barrel to US\$19.20/barrel in the current fiscal year—close to the latest Desjardins Equity Research projections. Next year, we forecast a gap nearly US\$3/barrel wider than the US\$14.40/barrel expected in Budget 2022. That reflects expectations that it will take time for US Gulf Coast refinery capacity to return and for the market to absorb the flood of heavy sour crude from the US Strategic Petroleum Reserve. With the FY2023 differential sensitivity, that suggests a WCS-related drag of nearly \$1.5 billion in FY2024.

4. How Much New Spending?

With additional revenues, Alberta will be in a position to raise spending or transfers to households. That has indeed been the case in past fiscal updates following revenue windfalls (graph 4). Alberta has thus far planned some of the most modest pandemic-era spending increases of any province, and measures announced to combat affordability challenges have been relatively small so far in dollar terms. With inflation also at multi-decade highs, there will be pressure to loosen the purse strings. Indeed, recently released [ministerial mandate letters](#) indicate that addressing affordability challenges will be a focus for multiple ministries.

GRAPH 4
Government Has Used Past Windfalls to Ease Spending Restraint



Sources: Alberta Finance and Treasury Board, and Desjardins, Economic Studies

For new spending and policy, there are two principal constraints for policymakers and investors. First, measures to address affordability challenges must be time-limited and targeted towards lower-income Albertans. Otherwise, there's risk of exacerbating inflation. The second is how Alberta's per-capita spending plans compare to those of Quebec, Ontario, and British Columbia. This remained a fiscal anchor in Budget 2022, following the [Blue Ribbon Panel Report and Recommendations](#)

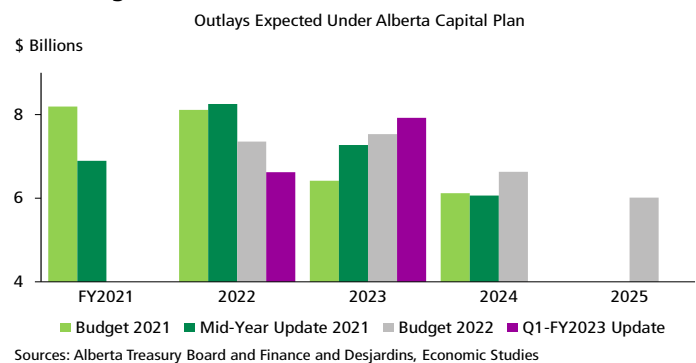
in 2019. Per Finance Canada's FY2022 Fiscal Reference Tables, Alberta's per-person program spending was less than that of Quebec in each of the last two years. However, it has outpaced that of Ontario and BC for most of the last two decades.

But with an election looming next year and the Q1-FY2023 update commitment to debt repayment, we suspect that any major new measures will wait until the spring 2023 budget. The mandate letter to the Minister of Finance said to cap operational spending at the rate of inflation plus population growth in Budget 2023. Based on Q1-FY2023 projections, that would mean an upper limit of about 5% operational spending growth in FY2024 versus a 1.9% forecast in Budget 2022. Hitting that upper limit would mean an additional \$2.3 billion in operating expenses next fiscal year.

5. Will Project Timelines Change Again?

In an environment of record labour shortages and decades-high input cost inflation, many provinces have already reported delays in capital spending plans. This includes Alberta, which reprofiled its Capital Plan in both Budget 2022 and the Q1-FY2023 update (graph 5). Large adjustments could impact the economic outlook and borrowing requirements. For instance, borrowing related to the Capital Plan was estimated at \$2.6 billion as of Q1-FY2023.

GRAPH 5
Project Timelines Alter Infrastructure Plans, Could Impact Borrowing



Sources: Alberta Treasury Board and Finance and Desjardins, Economic Studies

6. Will We Get Details on the Province's Debt Repayment Plan?

Any changes to the government's plan to repay \$13.4 billion in debt in FY2023 are also worth watching. The Q1 update stated that the "plan for using surplus cash will continue to be evaluated as the fiscal year unfolds." Clearly, funds available for debt repayment will be impacted by the province's underlying fiscal position, as well as any measures to address inflationary pressures, listed explicitly as a risk in Q1. The province will also weigh the relative merits of debt reduction and increased savings in an environment of rising rates.

7. How Much Will Spreads Move?

We suspect markets have already priced in much of any underlying fiscal improvement to be projected in the mid-year update. Most major Alberta long bond spread moves this year have tracked WTI, reflecting the longstanding fundamental relationship between the province's economic performance and oil prices. That said, spreads did tighten versus Ontario in late June after Alberta's Public Accounts reported an unexpected surplus, and again in early September following the Q1 update. Another positive surprise—on the revenue or expenditure side—could drive incremental tightening versus the other provinces.

With fundamentals so strongly in Alberta's favour, and long-term debt with an average term-to-maturity of 12 years as of Budget 2022, the province's bonds look like a solid hedge against inflation with limited risk related to interest rate rollover.

The Bottom Line

A solid outlook for oil prices despite recession headwinds and conservative prior projections mean that Alberta is likely to outperform Budget 2022 fiscal targets, but risks to the downside also merit consideration. The government's assumptions in this month's mid-year fiscal update will give investors and policymakers a sense of the size of these risks. Ultimately, the province will need to keep any new measures appropriately targeted and remain focused on long-run policy objectives, notably debt repayment and economic diversification.