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Research Update:

Province of Alberta Downgraded To 'A+' From 'AA' On Continuing Budgetary Performance Deterioration And Growing Debt

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Overview

- Alberta's projected deficits after capex over the next two years are among the highest of rated non-U.S. local and regional governments and, absent other measures, our expectation is that this will lead to further rapid growth in the province's debt burden.
- As a result, we are lowering our long-term issuer credit and senior unsecured debt ratings on Alberta two notches to 'A+' from 'AA' and affirming our short-term rating at 'A-1+'.
- We are also lowering our senior unsecured debt rating on Alberta's Crown Corporation, Alberta Capital Finance Authority, to 'A+' from 'AA'.
- The stable outlook reflects our expectations that Alberta will, on average, continue to post after-capital deficits of greater than 23% of total adjusted revenues in the next two years.

Rating Action

On May 26, 2017, S&P Global Ratings lowered its long-term issuer credit and senior unsecured debt ratings on the Province of Alberta two notches to 'A+' from 'AA'. At the same time, S&P Global Ratings affirmed its short-term debt rating on the province at 'A-1+'. The outlook is stable.

S&P Global Ratings also lowered its senior unsecured debt rating on its Crown Corporation, Alberta Capital Finance Authority (ACFA), to 'A+' from 'AA', and assigned an almost certain likelihood of support from the province based on the authority's critical role and integral link with the government, thereby equalizing the rating on ACFA with that on Alberta. We are no longer applying our "Guarantee Criteria" (published Oct. 21, 2016) to the authority because we believe that the Government-Related Entities criteria alone is the most appropriate framework to evaluate the rating implications of ACFA's essential role and tight link with the government.

Outlook

The stable outlook incorporates our expectation that, in the next two years, without material fiscal reforms in place to address budgetary shortfalls and by stimulating the economy with increased infrastructure spending, Alberta will continue to post, on average, significant after-capital deficits in excess of 23% of total adjusted revenues.

Downside scenario

While we believe a downgrade is unlikely in the next two years, we could lower the rating by one notch if the province significantly depleted its liquidity to address its structural budget shortfall. Such a depletion, coupled with a scenario that included prolific debt issuance and a lack of impactful fiscal policy responses, would cause us to weaken our financial management assessment.

Upside scenario

We could upgrade Alberta by one notch if an improvement in energy prices and resulting GDP growth were to lead to higher tax and resource revenues or the province successfully took measures to notably improve its budgetary performance, such that its after-capital performance improved with after-capital deficits better than 23% of total adjusted revenues.

Rationale

The downgrade reflects our assessment of the continued impact of depressed oil prices on Alberta's important resource revenues and the province's approach toward addressing its structural budget shortfall in a timeframe that is unlikely to prevent excessive growth in debt. To help stimulate the economy, the province has elevated its level of spending on infrastructure. As a result, in our fiscal 2016-2020 base-case forecast, our assessment of the province's budgetary performance particularly on an after-capital basis has significantly deteriorated and is materially weaker compared with that of both domestic and international peers. In addition, we expect that for Alberta to fund its growing capital expenditure program, its debt burden will continue to grow rapidly.

Low oil prices and elevated capital spending will continue to weigh on Alberta's budget and debt.

Under our base-case forecast for fiscal years 2016-2020, we expect that Alberta will record an average operating deficit of about 10% of operating revenues. Although Alberta's C$32.8 billion capital plan will stimulate the economy and help address its infrastructure deficit, we project the province will post deficits after capital expenditures exceeding 26% of total revenues in the next two years. This is higher than the budgetary results we had previously projected and of other domestic and international peers. In our opinion, Alberta's financial results are more volatile than those of other Canadian provinces because of the strong correlation of provincial revenues, especially non-renewable resource revenues, with oil and natural gas prices.

Given the larger deficits, we expect the pace of debt issuance to materially increase: From fiscal years 2018 to 2020, based on budget projections we anticipate Alberta will borrow just over C$55 billion. With this borrowing plan, we project total tax-supported debt to reach about C$94 billion by the end of fiscal 2020, or more than 180% of forecast operating revenues. This is a significant increase from debt levels recorded five years ago, when the province's tax-supported debt stood at C$29.3 billion or 60.1% of operating revenues. We estimate that interest expense should stay below 5% of projected operating revenues in the next two fiscal years. Our calculation of tax-supported debt includes guarantees and obligations under public-private partnership agreements and the debt of the province's wholly-owned financial institution, Alberta Treasury Branches (ATB), which we do not treat analytically as self-supporting, largely given its exposure to the Alberta energy sector and economy in general.

Nevertheless, we recognize that Alberta has good budgetary flexibility. Although it possesses strong tax advantages, compared with other Canadian provinces, that could be tapped, we believe it has yet to use these in a significant way to improve its fiscal position. We estimate that modifiable revenues and capital spending, on average, will represent about 84% of operating revenues and about 13% of total expenditures, respectively, for the fiscal 2016-2020 period.

The province, in our view, is focusing on controlling operating expenditure growth to less than the combined rate of population growth plus inflation to achieve smaller year-over-year deficits to balance. While the government did implement some moderate revenue measures in the last two years, no material fiscal measures were announced in the 2017 budget. Rather, it appears to us that the government is partly looking to a recovery in oil prices to improve its fiscal position. Nevertheless, from a budgeting standpoint, we believe that Alberta has a coherent financial plan that provides visibility, with well-documented assumptions and strong managerial expertise. We also believe that debt and liquidity are prudently managed and that budget practices are better than those of most peers.

Alberta's liquidity remains a key pillar of its creditworthiness, with estimated free cash balances of about C$14.6 billion. This will cover more than 280% of fiscal 2018 budgeted debt service, which is very strong among Canadian provinces. Although we expect liquidity levels to modestly decline in the next two years, we expect that they will cover well over 100% of debt service. Of note, the province has consistently stated that it will not spend any of the C$15 billion in the Heritage Savings Trust Account. It also has demonstrated strong access to Canada's well-developed capital markets.

Alberta's largest contingent liability is to ATB, a local financial institution for which the province is the sole owner and provides a guarantee to depositors. Total deposits and other liabilities of ATB were C$31 billion at the end of fiscal 2016. The province's other contingent liabilities represented less than 20% of adjusted operating revenue in fiscal 2017.

High wealth and a stable and predictable institutional framework underpin the ratings.
Alberta's economy continues to possess strong fundamentals, despite its economic concentration in the oil and gas industry and the related negative real GDP growth recorded in the past two years. In 2016, the industry, which includes supporting activities, represented about 20% of real GDP. This exposure brings economic and fiscal volatility, as evidenced by the decline in the price of oil that began in 2014 and the attendant effects on the provincial growth and the labor market. Nevertheless, the economy is very wealthy, with high levels of GDP and income levels per capita by virtue of Alberta's oil and gas sector. We estimate the average provincial GDP per capita to be about US$64,870 (2015–2017F), which is high compared with that of domestic and international peers. For 2017, the province expects real and nominal GDP to increase by 2.6% and 5.3%, respectively, with exports and rebuilding efforts in Fort McMurray driving the return to growth. We expect the recovery to be moderate, because investment outside the energy sector will remain hampered by declining private-sector construction spending. Nevertheless, increased infrastructure spending by the provincial government is likely to mitigate this somewhat. Moderate increases in oil prices are expected in large part due to the 2017 extension of production cuts by OPEC. We estimate that real GDP should rebound in 2018, with growth over 2.0%.

The ratings also benefit from the very predictable and well-balanced institutional framework in which Alberta operates. The Canadian constitution is the cornerstone of federal-provincial intergovernmental arrangements, which we view as mature and stable. The federal government provides revenue support through a number of agreements and transfer arrangements including the Canada Health Transfer and Canada Social Transfer payments. For fiscal 2017 (year ended March 31), these transfers constituted an estimated 18% of provincial adjusted operating revenues. The agreements covering these transfers are long-term, formula-driven, and predictable, but can be subject to change. Typically, the federal and provincial governments discuss proposed changes to transfer programs well ahead of their implementation.

Key Statistics

Table 1

Province of Alberta -- Selected Indicators

	--Budget year March 31--						
(Mil. C$)	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**	**2019bc**
Operating revenues	48,665	48,773	41,879	42,287	43,495	46,186	50,194
Operating expenditures	43,828	43,464	44,632	48,992	48,931	51,393	52,945
Operating balance	4,837	5,309	(2,753)	(6,705)	(5,436)	(5,207)	(2,751)
Operating balance (% of operating revenues)	9.9	10.9	(6.6)	(15.9)	(12.5)	(11.3)	(5.5)
Capital revenues	491	483	437	466	842	566	390
Capital expenditures	5,002	6,181	6,558	6,954	8,716	7,596	7,730

Table 1

Province of Alberta -- Selected Indicators (cont.)							
	--Budget year March 31--						
(Mil. C$)	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**	**2019bc**
Balance after capital accounts	326	(389)	(8,874)	(13,193)	(13,310)	(12,237)	(10,091)
Balance after capital accounts (% of total revenues)	0.7	(0.8)	(21.0)	(30.9)	(30.0)	(26.2)	(19.9)
Debt repaid	12,831	15,903	1,538	2,586	3,636	2,786	4,553
Gross borrowings	18,261	6,009	8,895	15,574	18,662	17,724	18,374
Balance after borrowings	5,756	(10,283)	(1,517)	(205)	1,716	2,701	3,730
Modifiable revenues (% of operating revenues)	86.5	88.7	84.0	82.3	83.6	84.2	84.7
Capital expenditures (% of total expenditures)	10.2	12.5	12.8	12.4	15.1	12.9	12.7
Direct debt (outstanding at year-end)	26,742	30,389	40,195	53,164	67,855	81,808	91,510
Direct debt (% of operating revenues)	55.0	62.3	96.0	125.7	156.0	177.1	182.3
Tax-supported debt (outstanding at year-end)	29,269	33,086	43,008	55,914	70,433	84,249	93,781
Tax-supported debt (% of consolidated operating revenues)	60.1	67.8	102.7	132.2	161.9	182.4	186.8
Interest (% of operating revenues)	1.2	1.5	1.9	2.4	3.2	3.9	4.6
Local GDP per capita (single units)	85,676	90,763	78,100	72,155	75,546	78,544	82,190
National GDP per capita (single units)	53,975	55,792	55,405	55,857	57,465	59,005	60,636

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. Budget year 2016 equals fiscal year 2017.

Ratings Score Snapshot

Table 2

Province of Alberta -- Rating Score Snapshot	
Key Rating Factors	**Assessment**
Institutional Framework	Very predictable and well balanced
Economy	Strong
Financial Management	Strong
Budgetary Flexibility	Strong
Budgetary Performance	Very weak
Liquidity	Exceptional
Debt Burden	Very high
Contingent Liabilities	Moderate

*S&P Global Ratings' ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the government's foreign currency rating.

Key Sovereign Statistics

Sovereign Risk Indicators, April 7, 2017. Interactive version available at http://www/spratings.com/sri

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Governments - International Public Finance: Methodology And Assumptions: The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment, Dec. 15, 2008

Related Research

- Americas Economic Snapshots--April, 2017
- Annual International Public Finance Default Study and Rating Transitions, June 30, 2016
- Public Finance System Overview: Canadian Provinces, Dec. 1, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that financial management, debt burden, and contingent liabilities had deteriorated. All other key rating factors were unchanged. Key rating factors are reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Alberta (Province of)		
Issuer Credit Rating	A+/Stable/A-1+	AA/Negative/A-1+

Downgraded

	To	From
Alberta (Province of)		
Senior Unsecured	A+	AA
Alberta Capital Finance Authority		
Senior Unsecured	A+	AA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.