

Fitch Affirms Province of Ontario, Canada's IDR at 'AA-'; Outlook Stable

Fitch Ratings, New York, 19 June 2017: Fitch Ratings has affirmed the following ratings for the Province of Ontario, Canada (the province):

- Long-Term Issuer Default Rating (IDR) at 'AA-';
- Long-Term Local Currency IDR at 'AA-';
- Short-Term IDR rating at 'F1+'.

The Rating Outlook is Stable.

SECURITY

Bonds are senior unsecured obligations of the province to which the province's full faith and credit is pledged. Commercial paper notes are promissory notes ranking equally with Ontario's other unsubordinated and unsecured indebtedness.

KEY RATING DRIVERS

FISCAL CONSOLIDATION CONCLUDES: The tabled budget for fiscal 2018 completes the province's plan to eliminate its annual budget deficits by fiscal 2018. Despite some variations to the plan announced in the 2010 budget, the province has remained committed to this fiscal goal.

STRONG FINANCIAL MANAGEMENT: The province has demonstrated the ability to exert considerable expenditure restraint while instituting revenue changes to achieve its deficit reduction objectives. Maintaining restraint in future fiscal years will remain a key challenge for the province, in Fitch's view, as an elevated debt burden and limited contingency lines otherwise limit its flexibility to absorb a future economic slowdown without added borrowing.

SIGNIFICANT ACCUMULATED DEFICIT: The province estimates an accumulated deficit equal to 145% of operating revenues in fiscal 2017 (24% of gross domestic product [GDP]) fueled by the past misalignment between annual revenues and expenditures. The province forecasts continued, gradual declines in the accumulated deficit as a proportion of GDP based on economic growth assumptions.

SIZABLE, DIVERSE ECONOMY: The province's diverse economy includes Canada's largest business and financial hub and accounts for 39% of the country's population. Growth in trade, financial services, and education and health care services has

expanded the economic base, with manufacturing now a much smaller share. The provincial economy remains heavily linked to that of the U.S.

LARGE AND GROWING DEBT BURDEN: The province's debt burden measured by net direct debt to GDP is high, although debt service consumes a manageable 8% of annual revenues. Net debt is likely to grow in fiscal years 2018 through 2020 in support of the province's robust infrastructure program, with the forecast decline in debt burden relying on continued economic growth.

RATING SENSITIVITIES

FISCAL PRUDENCE: The Stable Outlook at the current rating level assumes the Province retains its focus on tabling balanced budgets and gradually lowering the burden of debt. The resumption of significant borrowing to support operating deficits would result in negative pressure on the rating.

CREDIT PROFILE

Ontario's 'AA-' rating is supported by its wealthy, diversified economy and generally sound financial management. The province has concluded its fiscal consolidation program first articulated in its 2010 budget, with a balanced budget tabled for fiscal 2018. Budget balance has been achieved through steady economic and revenue growth, expenditure restraint, introduction of new revenue measures, as well as the sale of provincial assets to fund components of the capital program.

The most significant asset sales have occurred over the past year and a half, with approximately 60% of provincial ownership in Hydro One, the province's electricity transmission and distribution utility, sold through public offerings. The share sales have provided approximately C\$5 billion toward the repayment of outstanding debt on the utility and about C\$4 billion toward the province's capital program. The plan is currently on track to net the province C\$5.7 billion over time, with funds dedicated to its Trillium Trust.

LARGE, DIVERSE ECONOMIC BASE

The province is Canada's largest by population, and its diverse economy generates 38% of Canada's GDP. Provincial GDP gains have been steady since the recession. Improved U.S. demand and lower crude oil prices have helped support economic growth in Ontario, with GDP now exceeding national averages;

in 2015 GDP rose 2.6% compared to Canada's 0.9% and in 2016 provincial employment rose 1.1% compared to Canada at 0.7%.

Manufacturing, which was severely affected in the last recession, has become a much less significant driver of the province's economy. Other sectors have seen robust growth, including in trade and transportation, financial activities, and education and health services.

The province continues to forecast steady economic growth in the medium term, with forecast real GDP rising 2.3% in 2017 and 2.1% in 2018. The forecast is currently supported by a favorable export position and federal government stimulus while incorporating the province's recently adopted Fair Housing Plan; a multi-pronged approach to address escalating housing values and housing affordability in the Greater Toronto region. Although some cooling from the plan is evident in recent real estate market data, the risk of a more severe housing market decline remains possible.

Downside risks to the forecast remain; these include slower economic growth in the U.S., rising interest rates, pressured housing markets beyond that included in the current forecast, increases in crude oil prices and financial sector exposure to the resource provinces.

FINANCIAL BALANCE OBTAINED BUT SLIM CUSHIONS ARE FORECAST

Ontario's fiscal 2010 ended with a C\$19.3 billion operating deficit (20% of revenues) and an accumulated financial deficit of almost C\$131 billion (136% of revenues). The province adopted a multiyear fiscal consolidation plan with the goal of reaching a balanced budget by fiscal 2018. Despite a setback in fiscal 2014, through fiscal 2017 the province has exceeded its targets.

At the close of fiscal 2017, the annual operating deficit is estimated at C\$1.5 billion while the accumulated deficit peaks at C\$193.5 billion. Fiscal 2017 benefits from the sale of shares in Hydro One and strong performance in the housing market and government enterprises, offset by the tax impact of slightly under-forecast economic growth. To achieve annual deficit reduction targets, additional expenditure restraint was required.

The tabled budget for fiscal 2018 concludes the province's fiscal consolidation with a balanced budget forecast at year-end. Continued economic strength is expected to support core personal income and consumption taxes, with additional

receipts from the province's new cap-and-trade program and from federal government infrastructure support. Overall 6.3% growth in operating revenues, inclusive of tax measures and adjustments, exceeds the 4.7% growth in expenditures, including expansive 10.4% growth in programs.

Expenditures have been expanded to incorporate the province's new Fair Hydro Plan, a multi-year program to reduce household electricity bills through two means; a rebate to residential customers equivalent to the 8% provincial portion of the harmonized sales tax on electricity bills and the refinancing of existing electricity infrastructure. These measures add \$2.5 billion in annual expense over the next three fiscal years. Other program expansions include targeted increases in health care and education, including capital investments.

Provincial reserves are expected to remain slim over the near-term, with a modest C\$600 million set aside in both fiscal years 2018 and 2019. While the province has exemplified significant expenditure controls to resolve budgetary shortfalls and the willingness to raise additional revenue, the slimness of the financial cushion is a credit weakness particularly when confronted by a future economic slowdown.

SIGNIFICANT DEBT BURDEN AND ACCUMULATED DEFICIT

Achieving its fiscal balance goal of fiscal 2018 has left the province with a sizable accumulated deficit, equal to C\$193.5 billion in fiscal 2017, and a debt burden that has reached a substantial 37.8% of GDP. While the province's need to finance fiscal imbalances has dropped off with the fiscal 2018 budget, planned capital continues and outstanding debt is forecast to increase over the medium-term.

The fiscal 2018 budget provides target dates for achieving the province's long-stated goal of bringing debt-to-GDP to 27%; the budget sets an interim target at 35% in fiscal 2024 and 27% in fiscal 2030. This very slow decline relies almost completely on continued economic growth as total long-term borrowing for infrastructure is expected to escalate over the next few years. Total borrowing in fiscal 2018 is forecast at approximately C\$26.4 billion, of which C\$13.1 billion is for capital purposes, C\$6 billion is to bolster the province's cash position and the remainder largely for repaying debt maturities. Interest on outstanding debt remains manageable, at 8% of expenditures in fiscal 2018.

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