Commentary

Travis Shaw
Vice President
Public Finance
Global Corporates
+1 (416) 597 7582
tshaw@dbrs.com

Paul LeBane
Vice President
Public Finance
Global Corporates
+1 (416) 597 7478
plebane@dbrs.com

Brenda Lum
Managing Director
Real Estate & Public Finance
Global Corporates
+1 (416) 597 7569
blum@dbrs.com

Insight beyond the rating.

Ontario's 2018 Budget: Billions for the Ballot

DBRS Limited (DBRS) is commenting on the Province of Ontario's (Ontario or the Province; rated AA (low) with a Stable trend by DBRS) 2018 budget, released on March 28, 2018.

After almost a decade of reiterating its commitment to a balanced budget and reducing the Province's debt-to-gross domestic product (GDP) ratio, the Province has introduced a plan that will see it ramp up spending ahead of the June 2018 provincial election, voluntarily pushing itself back into protracted deficit spending and halting the improvement in debt ratios.

The direction of fiscal policy adopted by the Province is distinctly negative for the Province's credit profile. Rather than shifting to a neutral or conservative fiscal policy stance and rebuilding budget and balance sheet flexibility, the Province has made a deliberate decision to pursue expansionary fiscal policy potentially near the peak of the economic cycle.

The budget proposes deficits in the range of $6.5 billion to $6.7 billion in each of the next three years. The plan to return to balance — aptly termed a "recovery plan" — sees the Province gradually reducing the deficit during a subsequent mandate with a target to balance the budget in 2024–25. In total, the budget projects about $32.0 billion in deficit spending and about $90.0 billion in debt-financed capital investment over the next six years. It demonstrates in the clearest terms that the Province is not committed to disciplined, countercyclical fiscal policy. The policy reversal also undermines the credibility of the government's future fiscal policy commitments, including its plan to return to balance.

With no willingness to balance the budget at the peak of the business cycle and by systematically expanding government, a return to protracted deficit spending appears all but certain. With interest rates set to rise, economic growth expected to moderate and program spending entrenched, eliminating the budget deficit will prove challenging in the coming years.

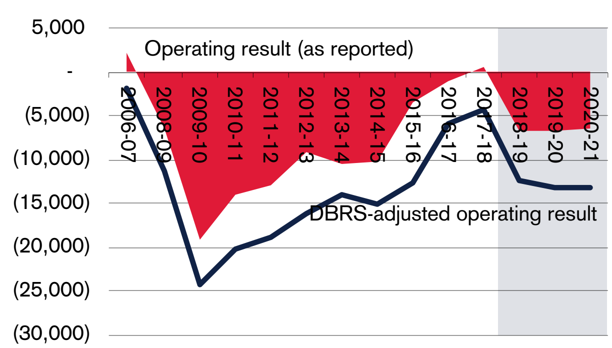
Ontario's credit profile stabilized in recent years and was beginning to show modest signs of improvement. Progress will now likely stall or reverse. While DBRS expects the ratings to remain stable in the near term, the outlook for the medium to longer term appear less certain. Without a concerted effort to rebuild flexibility in the credit profile, the Province's ratings appear increasingly likely to come under pressure during the next recession if past policy actions are any indication of the future policy response.

Budget 2018 Take-Aways

- Ontario Liberals are no longer committed to balanced budgets or prudent, countercyclical fiscal policy.
- Credibility of Ontario's future fiscal policy commitments has been undermined by the dramatic fiscal policy reversal.
- Ontario has proposed $20.3 billion in new program spending over the next three years. The budget includes modest tax increases, with the bulk of new spending being debt-financed.
- Deficits are pegged at between $6.5 billion and $6.7 billion in each of the next three years.
- The "responsible fiscal recovery plan" — to a self-imposed problem — begins in 2021–22 and targets a balanced budget in 2024–25.
- Between 2007–08 and 2017–18, DBRS-adjusted debt will have risen by nearly $200 billion. The plan suggests debt will rise by a further $40 billion over the next three years.
- DBRS-adjusted debt-to-GDP appears likely to remain near current levels (42.0% to 43.0%) over the next three years, providing the economic expansion continues. Debt appears certain to remain permanently above pre-recession levels (26.0%) over the longer term.
- **Political uncertainty:** Current polling suggests a change in government may be possible with the June 7, 2018, election. If this were to occur, the fiscal plan could change significantly.
- **Economic risks:** Rising trade protectionism/isolationism, BREXIT, China's economic transition, household indebtedness, rising interest rates and U.S. fiscal policy all pose potential risks to the Ontario economy.

Exhibit 1: Fiscal Outlook

Reported and DBRS-Adjusted Operating Result ($ Millions)



Sources: Province of Ontario and DBRS.

Budget Outlook

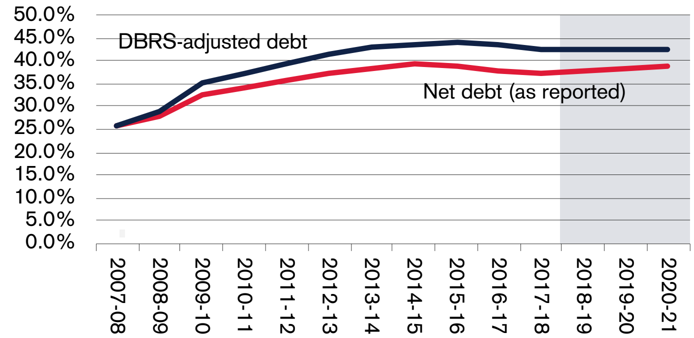
The Province's 2018 budget will not be passed ahead of the June 2018 general provincial election, but it does set out the incumbent Liberal's priorities if elected for another mandate.

Thematically, the focus of the budget is new spending measures consistent with the government's vision for creating fairness and opportunity. The budget includes more $20.3 billion in new spending over the next three years. There are no major economic or tax policy announcements.

The budget projects a deficit of $6.7 billion in 2018–19 or 0.8% of GDP, though, as in past years the budget does incorporate a general budgetary reserve ($700 million) and explicit expense contingencies ($1.6 billion). On a DBRS-adjusted basis (post-capex), this equates to a deficit of about $13.0 billion, or about 1.4% of GDP.

Exhibit 2: Debt Burden

Net Debt and DBRS-Adjusted Debt as a Share of GDP



Sources: Province of Ontario and DBRS.

Total revenue is set to rise modestly (+1.5%). Underlying tax (+4.3) and transfer (+2.7%) revenue growth are moderately strong, but are being offset by declines in government business enterprises' net income and other own-source revenue, both of which are related to policy actions that bumped up revenue in the prior year (e.g., one-time gains from Hydro One share sale, elimination of electricity debt retirement charge, etc.). The budget includes only modest tax policy changes, the most significant of which are changes to the personal income tax rate structure and surtax, which will provide about $500 million in incremental revenue in 2018–19 and between $700 and $800 million in the outer years. There is no concerted effort to increase taxes to pay for the new spending commitments.

Total expense is set to rise strongly (+6.0%) in 2018–19, which follows a similarly strong increase the year before (+5.5%). These are the fastest spending increases since the peak of the financial crisis (2009–10). The 2018 budget outlines $20.3 billion in major, new spending initiatives over three years. These include:

- Increased funding for hospitals/health care (+$1.3 billion);
- Improved services and access to mental health and addictions services (+$1.2 billion);
- Improved affordability/access to childcare, including free preschool for children two and a half and older (+$2.2 billion);
- Social assistance and income security reform (+$2.3 billion);
- Increased support for individuals with development disabilities (+$1.8 billion);
- Free prescription drugs (extension of OHIP+) for senior citizens (+$1.0 billion);
- Senior's healthy home program (+$0.7 billion);
- New drug and dental program for individuals without workplace coverage (+$0.8 billion); and
- More funding for economic development and similar activities (+$0.9 billion).

The new program spending is translating into significant growth in ministry budgets: Health and Long-Term Care (+5.1%), Education (+4.4%), Advanced Education and Skills Development (+5.9%) and Community and Social Services (+7.5%), as well as interest on debt (+4.8%).

Capital spending is set to rise strongly (+22.6%) in 2018–19, with growth in both grants and capital investment. Capital investment by the Province (not included in expense) is budgeted to rise by nearly $3.0 billion to $16.1 billion, which follows a similar-sized increase in the prior year.

The Province has projected deficits in the range of $6.5 billion to $6.7 billion for the 2018–19 to 2020–21 period. These estimates include contingencies and budget reserves. While spending growth is substantial in 2018–19, the Province projects moderation in both revenue and spending growth in subsequent years, with revenue and expense growth ranging between 3.0% and 4.0% annually.

The Province has outlined a plan to return to balance (responsible fiscal recovery plan) with the deficit gradually falling after 2020–21 and the budget eventually being balanced in 2024–25. Given the recent policy reversal and that deficit reduction is set to coincide with the 2022 general election, DBRS questions the credibility of the targets.

While the policy announcements are concerning, DBRS does note that Ontario has exceeded its deficit targets in recent years. The budget incorporates contingencies and the Province has over-estimated debt servicing costs in the past. Moreover, new in-year spending has often been offset by better-than-expected revenue and capital investment tends to be less than budgeted. Ultimately, this has translated into debt often being lower than forecast.

Debt Outlook

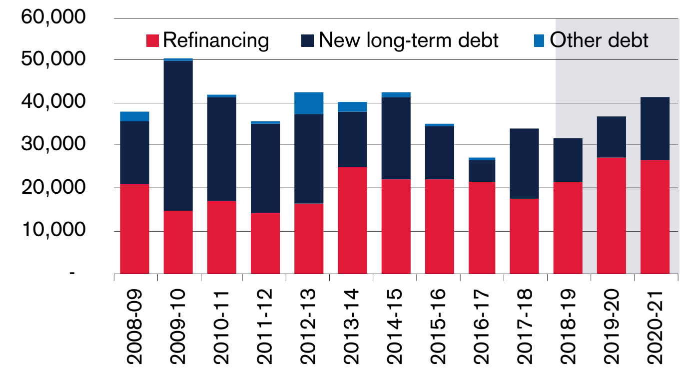
The budget suggests the Province's DBRS-adjusted debt burden will remain near current levels (42.0% to 43.0% of GDP) over the next three years. This halts the downward trend in the debt burden that began in 2016–17.

Ontario projects net debt, as reported in financial statements, will rise $16.8 billion (+5.5%) to $325.0 billion in 2018–19, or increase modestly to 37.6% of GDP. The Province announced last year that it would reduce the net debt-to-GDP ratio to 35.0% by 2023–24 and to pre-recession levels in 2030s. The debt reduction goal has now been abandoned, less than a year later.

The Province's borrowing requirement for 2018–19 is $31.7 billion, after accounting for $11.5 billion in pre-borrowing completed in 2017–18. This includes $21.5 billion for refinancing, $14.2 billion for capital requirements and the remainder is for various other cash requirements, including the deficit. Over the medium term, the borrowing plan will remain elevated with rising refinancing requirements and persistent deficit spending.

Exhibit 3: Borrowing Program

Historical Financing Activity and Borrowing Program ($ Millions)



Source: Province of Ontario.

Economic Outlook

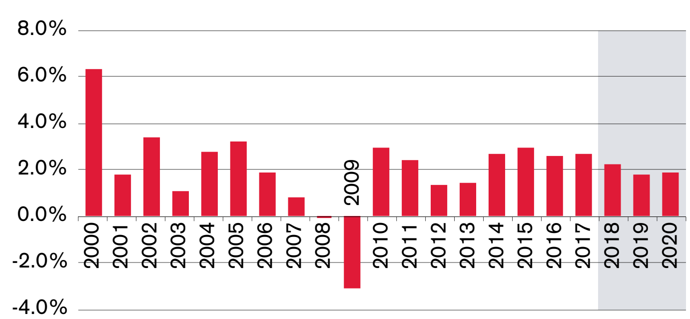
Ontario's economy has continued its broad-based expansion with real GDP growth estimated at 2.7% in 2017.

The Province expects economic expansion to continue over the medium term with household consumption, business investment and government spending driving growth. The labour market is forecast to tighten further over the medium term with unemployment tracking to 5.4% over the next two years. While residential investment has been a significant contributor to growth in recent years, the Province now expects residential investment to moderate, due in part to past policy measures, rising interest rates and the changes in Office of the Superintendent of Financial Institutions mortgage rules.

Economic growth is projected to be 2.2% in 2018 and average 1.9% over the medium term.

Exhibit 4: Economic Growth

Real GDP Growth (%)



Sources: Statistics Canada/Haver Analytics and Province of Ontario.

The economic outlook continues to be supported by a strong U.S. economy, though the Province does face a number of significant economic risks, including U.S. trade and fiscal policy, rising interest rates, Brexit, elevated sovereign indebtedness and China's economic transition.

Qualified Financial Statements

Ontario's budget presentation is broadly consistent with that of its audited public accounts. The Auditor General has, however, qualified the financial statements in each of the last two years and has indicated that she is likely to add a further qualification in 2017–18 if the Province accounts for the Fair Hydro Plan as is currently proposed.

The 2016–17 Audit Report indicated that the deficit was understated by $1.4 billion and that net debt was understated by $12.4 billion (equivalent to 1.6% of nominal GDP). The 2018 Budget does not provide disaggregated balance sheet data, but given the performance of the underlying pension plans in recent years and the budget projection for other net assets, the reported net pension asset appears likely to rise. With Ontario Fair Hydro Trust expected to borrow about $2.0 billion annually over the coming years, the Auditor General would likely argue that the deficit is understated by more than $3.0 billion in 2018–19 and that the net debt is likely understated by between $15.0 and $20.0 billion (1.7% to 2.3% of GDP).

In rating Canadian provinces, DBRS uses an adjusted measure for debt based on the liabilities reported by the Province. For Ontario, DBRS-adjusted debt includes a portion of the Fair Hydro-related borrowings and does not include the value of the net pension asset. For more detail on DBRS's calculation of debt, refer to the methodology, *Rating Canadian Provincial Governments*, available at www.dbrs.com.

June 2018 Provincial Election

The next provincial general election is scheduled for June 7, 2018. Current polls suggest a change in government may be possible, as is the possibility of a minority government. Neither of the opposition parties has yet to release a comprehensive election platform. It is not clear how fiscal policy would evolve under a different government.

The opposition parties have criticized government for the qualified audit opinion and the financing structure used for the Fair Hydro Plan. A change in government could lead to a change in the structure of the Fair Hydro financing or the accounting of the net pension asset. If this were to occur, the reported deficit would likely deteriorate further and net debt would step up. Depending on how a restructuring occurred, DBRS could adjust the DBRS-adjusted debt and deficit measures.

Ontario's *Fiscal Transparency and Accountability Act* requires the government release a pre-election report on the state of the Province's finances. The report, released concurrent with the 2018 budget, outlines the economic assumptions used to develop the Province's fiscal plan, an estimate of revenue and expenses and the Province's debt-to-GDP ratio. The report will be reviewed by the Auditor General for reasonableness. DBRS expects the Auditor General will issue a negative opinion on the report.

Preliminary Assessment

This commentary reflects a preliminary assessment of the Province's budget. DBRS will conduct a formal, in-depth review of the Province in the coming weeks and will publish a rating update at the conclusion of that process.

Appendix — Historical Budget Accuracy

Exhibit A1: Fiscal Projections — Budget vs. Actual
(As Presented by the Province; $ Millions)

	Budgeted					Actual					Variance (Actual to Budget)				
	2013–14	2014–15	2015–16	2016–17	2017–18	2013–14	2014–15	2015–16	2016–17	2017–18	2013–14	2014–15	2015–16	2016–17	2017–18
Revenue	116,845	118,871	124,390	138,482	150,019	115,911	118,546	128,377	140,734	150,136	(934)	(325)	3,987	2,252	117
Program Expense	117,983	120,366	121,492	130,376	137,773	115,792	118,226	122,439	130,016	137,529	(2,191)	(2,140)	947	(360)	(244)
Interest Expense	10,605	11,010	11,410	12,412	12,246	10,572	10,635	10,967	11,709	11,965	(33)	(375)	(443)	(703)	(281)
Total Expense	128,588	131,376	132,902	142,788	150,019	126,364	128,861	133,406	141,725	149,494	(2,224)	(2,515)	504	(1,063)	(525)
Surplus (Deficit)	**(11,743)**	**(12,505)**	**(8,512)**	**(4,306)**	**–**	**(10,453)**	**(10,315)**	**(5,029)**	**(991)**	**642**	**1,290**	**2,190**	**3,483**	**3,315**	**642**
Capital Investment	12,529	12,167	11,138	13,037	15,566	10,322	11,183	10,922	10,045	13,100	(2,207)	(984)	(216)	(2,992)	(2,466)
Net Debt	**272,810**	**289,251**	**298,864**	**308,315**	**311,921**	**267,190**	**284,576**	**305,233**	**301,648**	**308,203**	**(5,620)**	**(4,675)**	**6,369**	**(6,667)**	**(3,718)**

Budgetary results and debt are consistently better than projected.

Exhibit A2: Economic Assumptions — Budget vs. Actual
(Per Cent or Percentage Points (Variance))

	Budgeted (%)					Actual (%)					Variance (Ppts.)				
	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
Nominal GDP Growth	3.0	3.5	4.2	4.0	4.3	2.4	4.1	4.9	4.3	4.4	(0.6)	0.6	0.7	0.3	0.1
Real GDP Growth	1.5	2.1	2.7	2.2	2.3	1.3	2.7	2.5	2.6	2.7	(0.2)	0.6	(0.2)	0.4	0.4

Exhibit A3: DBRS-Adjusted Operating Results and Debt
(As a Share of GDP)

	Budgeted (%)					Actual (%; First Statistics Canada Estimate)					Variance (Ppts.)				
	2013–14	2014–15	2015–16	2016–17	2017–18	2013–14	2014–15	2015–16	2016–17	2017–18	2013–14	2014–15	2015–16	2016–17	2017–18
DBRS-Adj. Operating Result	(2.7)	(2.1)	(1.7)	(2.6)	(2.3)	(2.2)	(2.0)	(2.8)	(2.4)	-	0.5	0.1	(1.1)	0.2	-
DBRS-Adj. Debt	37.3	38.6	39.6	44.1	44.0	38.2	38.2	42.0	43.0	-	0.9	(0.4)	2.4	(1.1)	-

Methodology and Data: Budgeted and actual amounts for 2013–14 to 2016–17 are taken from Ontario's public accounts. The budgeted reserve has been included in program expense. Budgeted amounts for 2017–18 are taken from the 2017 Budget and the actual amounts for 2017–18 are taken from the 2018 Budget. Budget GDP growth is taken from provincial budgets and the associated actuals are the first GDP estimate (expenditure basis) produced by Statistics Canada. The actual GDP growth for 2017 is the Province's projection in the 2018 Budget. The DBRS-adjusted figures are taken from rating reports, with the actual figure being the estimate/actual taken from the subsequent year's report.

Note:
All figures are in Canadian dollars unless otherwise noted.