# 2017 Document Fiscal Architecture:
## Update on the Fiscal Challenge

Office of the Budget
MINISTRY of FINANCE

Presentation to Fiscal Prep Committee on January 12, 2016

Preliminary Draft (All numbers to be Confirmed) – January 11, 2017 11:00 AM

# Purpose

Provide a status update on the fiscal gap as context for a discussion on tools to close the gap.

Set the stage for the January 18th MMP.

# Evolution of Multi-Year Fiscal Challenge

While the 2016 Budget outlined a plan to balance the budget in 2017-18 and remain balanced in 2018-19, **changes since the Budget have created a gap compared to the government's fiscal targets**.

- A stronger outlook for revenue and lower interest on debt expense are currently tracking against the Budget forecast – **however, spending pressures, new strategic investments, and the pension adjustment have also materialized.**

The **2016 FES projected that the government could achieve its fiscal targets while accommodating several new investments and the pension adjustment.**

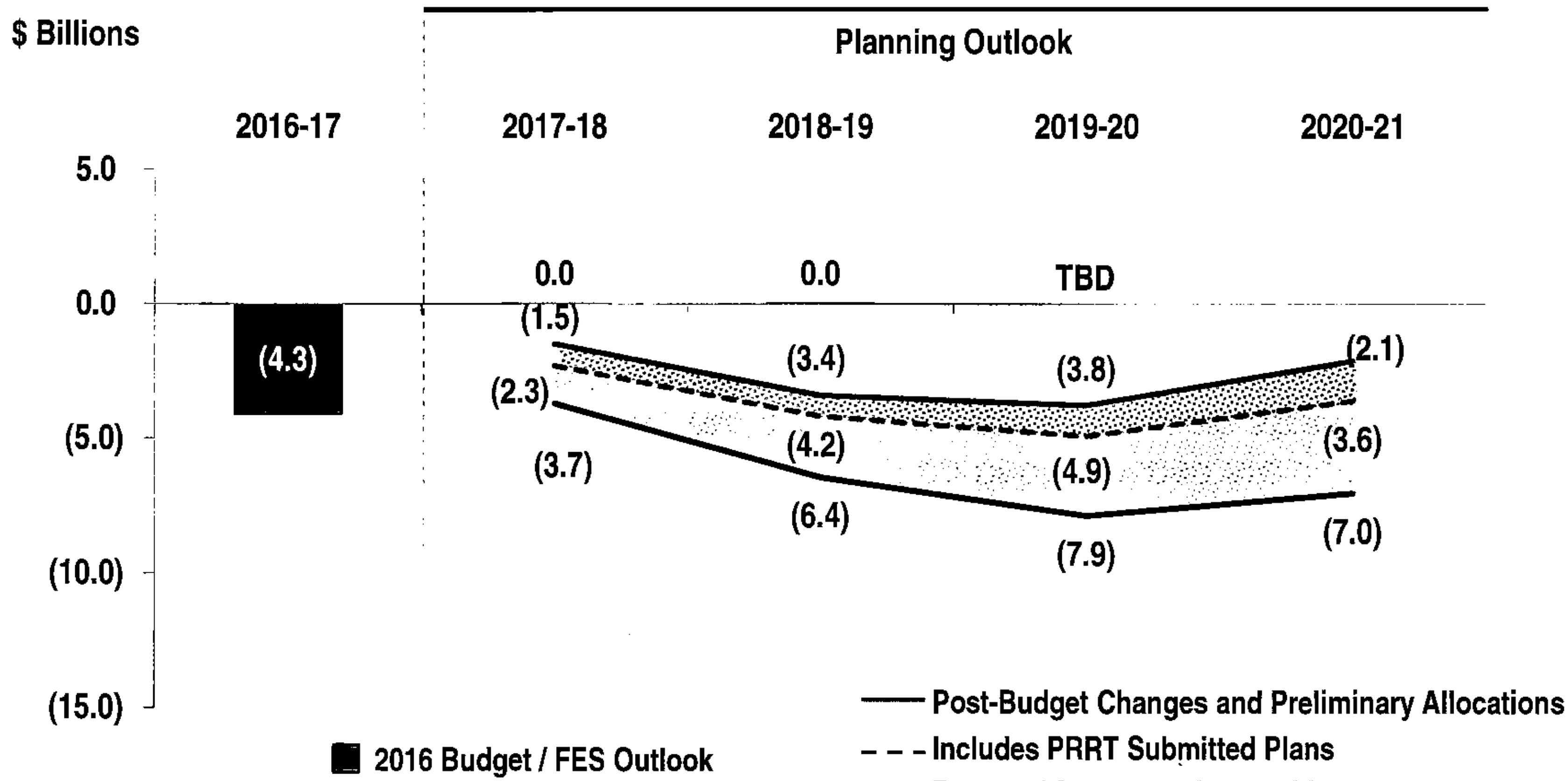
- However, **the FES fiscal outlook did not address** the potential fiscal impact of other known pressures, namely, those associated with preliminary allocations provided to ministries and other strategic investments under consideration.

Since the 2016 FES, the fiscal gap has deteriorated as a result of:

- **PRRT plans coming in above preliminary allocations** and the revised impact of **potential priority investments**.
- The **pension adjustment beyond 2018-19 not being fully offset by revenue/expense tools.**
- **Other changes to revenue**, including a downward revision in Ontario's Equalization entitlement and asset optimization forecasts.

# The Current Multi-Year Fiscal Challenge

As a result, in the absence of further actions, the projected gap tracking against the government's fiscal targets is currently as much as $3.7 billion in 2017-18, $6.4 billion in 2018-19, and $7.9 billion in 2019-20.

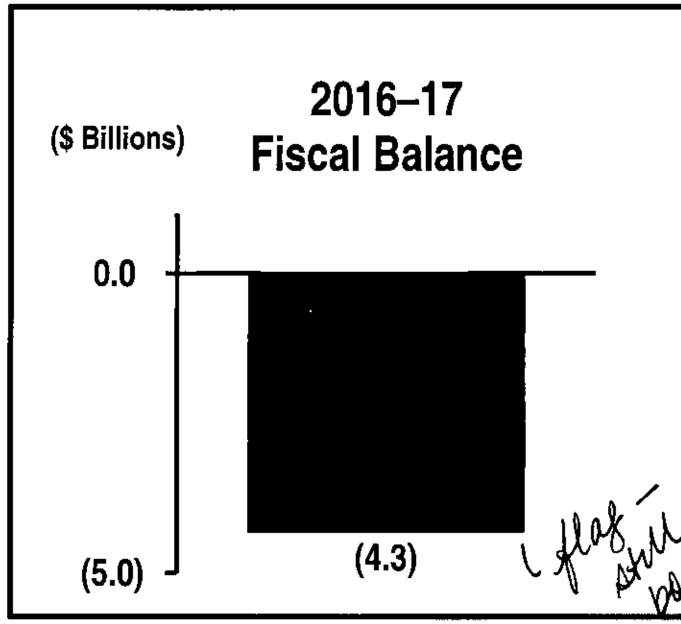


# 2016-17 Update

The FES projected a deficit of $4.3 billion in 2016-17, consistent with the 2016 Budget – however, despite a stronger revenue outlook and lower interest on debt expense, the reserve and contingency funds were reduced in order to accommodate the pension adjustment and new investments.

**There is key outstanding information/decisions that will be needed to land the interim outlook for inclusion in the 2017 Document:**

- Treatment of Pension Assets (plus any valuation impacts)
- Accounting Framework for OPG and Hydro One (IFRS)
- What fiscal year to book proceeds from the first cap and trade auction in March 2017 (i.e. 2016-17 or 2017-18)
- Updates to revenue and expense (based on ministry interim actual projections)
- Contaminated sites liabilities




flag – still balancing

**Third Quarter Finances**

Ontario's Third Quarter Finances is a public fiscal update. Under the *Fiscal Transparency and Accountability Act, 2004* (FTAA), the Third Quarter Finances is required to:

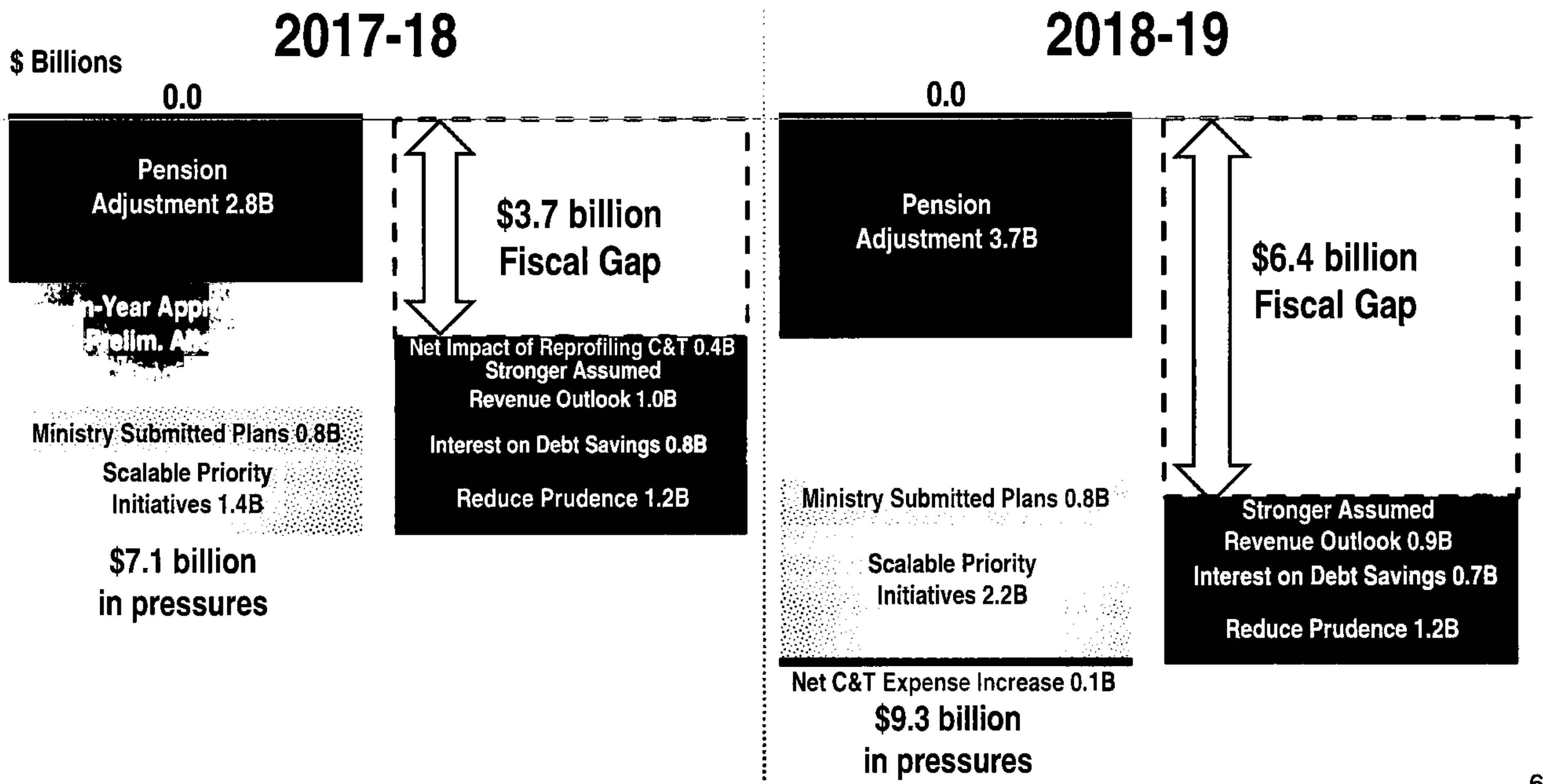
- Be released on or before February 15th; and
- Include updated information about the major components of revenue and expense for the current year (i.e. 2016-17).

It also provides an opportunity for the government to reiterate key fiscal messages from the Budget and Fall Economic Statement or pre-condition for the 2017 Budget.

# Update on the Fiscal Challenge

In order to accommodate fiscal pressures in 2017-18 and 2018-19, tools were taken on in the 2016 FES and the 2016 Budget.

The remaining fiscal gap will need to be addressed through additional tools.



[redacted]

# Other Factors That Could Further Impact the Gap

## Revenue

- Revisions to economic outlook
- Potential revisions to cap-and-trade proceeds based on auction results in 2017.
- Adjustments to the government's asset optimization strategy
- Remaining 2015 CIT & PIT tax assessment information and ongoing tax receipts from provincially administered taxes
- PRRT updates (revised revenue outlooks from ministries, agencies and government business enterprises)
- Implications of Federal Budget

## Expense

- Additional electricity price relief
- 2017 Document initiatives
- Labour settlements
- Interest on debt forecast updates
- Alignment of climate change investments with available proceeds
- Impact of expense pressures that ministries have been asked to manage

<u>Accounting risks:</u>

- Treatment of Pension Assets (plus any valuation impacts)
- Accounting Framework for OPG and Hydro One (IFRS)

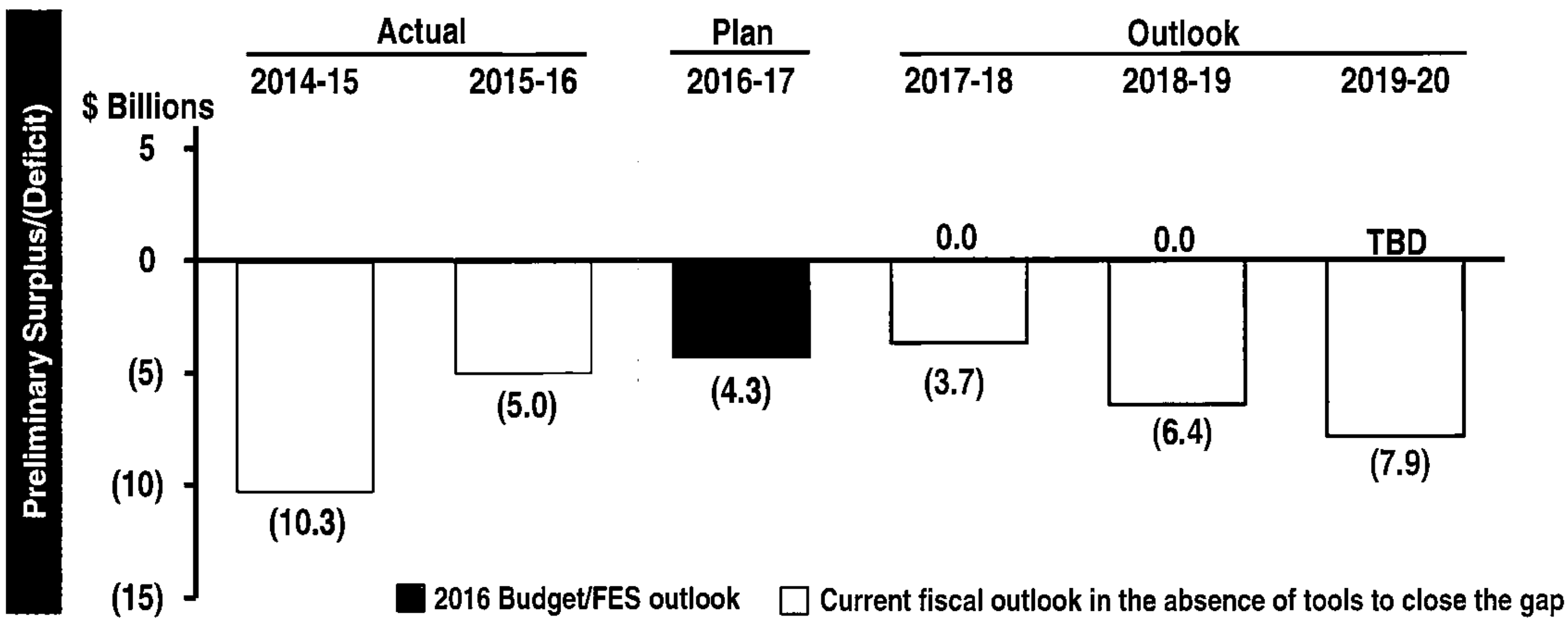
[illegible]

- Potential improvement to gap
- Potential improvement or deterioration to gap
- Potential deterioration to gap

# Fiscal Anchors over the Outlook

Fiscal anchors will need to be confirmed/established over the outlook to guide decision-making and the prioritization of tools:

| | | | | |
|---|---|---|---|---|
| **Fiscal Anchors** | **2017-18** Balance | **2018-19** Balance | **2019-20** TBD | **Net debt-to-GDP target** declining to pre-recession level of 27% |



# Potential Decisions to Achieve Fiscal Anchors

There are a number of revenue and expense measures that could be considered to achieve fiscal anchors.

### Additional Revenue Measures

- Determine the scope for revenue tools, including:
  - Tax measures
  - Asset optimization (move final tranche from 2018-19 to 2017-18)
  - Non-tax revenue
  - Paralleling federal tax measures

### Federal Revenue Strategy

- Engagement strategy with the federal government to maximize new federal funding, including:
  - Funding for climate change initiatives
  - × Infrastructure funding
  - Health funding

### Additional Expense Measures

- Determine the scope for expense measures, including:
  - Undertaking additional transformative initiatives
  - Revisiting in year approvals
  - Timing/scaling mandate letter commitments
  - Additional savings targets
- Interest on Debt Savings

### Review level of Prudence

- What is the appropriate level of the C-Fund and reserve that should be built into the fiscal plan?
  - × Further reductions to the reserve or C-Fund increase vulnerability to future forecast changes

× Measures have already been taken on. Achieving further fiscal effort from these measures will be challenging.

# Next Steps

<table>
<tr><td colspan="2">✓ STAGE 1 – Assessment of current fiscal plan (FPC, December 7, 2016)</td></tr>
<tr><td colspan="2">✓ STAGE 2 – Identified planning questions (FPC, December 15, 2016)</td></tr>
<tr><td colspan="2">STAGE 3 – Fiscal Architecture Planning for the 2017 Document</td></tr>
<tr><td>FPC Workshop<br>January 12</td><td>• Workshop discussion:<br>  • Review PRRT submissions above preliminary allocations<br>  • Discuss and prioritize scalable initiatives relative to the use of tools<br>  • Identifying available tools to close the gap</td></tr>
<tr><td>MMP Discussion<br>January 18</td><td>• Provide a fiscal update and outline key decisions, including:<br>  • Potential revenue and expense levers and tools<br>  • Strategic investments and PRRT decisions<br>  • Accounting risks</td></tr>
</table>

# Appendix

# Alternative Approaches to Fiscal Anchors

The government could consider alternative approaches to measure and communicate balance and fiscal sustainability. Each of these approaches would still require substantial fiscal effort in order to be able to communicate a credible narrative.

| Balancing Before the Reserve | Balancing Before the Reserve and Electricity | Balancing the Operating Budget Only | Shifting to a Net Debt-to-GDP Narrative | Postponing Balance Date |
|---|---|---|---|---|
| • The government could communicate that balance is achievable if the reserve is not needed.<br>• There may be scrutiny about inconsistent reporting of surplus/(deficit) targets, which have always included the reserve (per FTAA).<br>• Maintains a similar framework used in previous documents leading to the path to balance.<br>• Comparable with actual results and consistent with FAO reporting. | • The government could communicate that balance is achievable if the reserve is not needed and excludes investments in electricity price relief.<br>• The narrative could focus on running a surplus and indicate deficits are a result of investments to support managing the cost of electricity for Ontarians.<br>• May be scrutinized for introducing a new definition of balance in 2017-18. | • The government could exclude capital expense from the surplus/(deficit).<br>• The narrative could focus on running an operating surplus and indicate deficits are a result of capital investments to spur economic growth.<br>• May be scrutinized for introducing a new definition of balance in 2017-18. However, Ontario communicated operating surplus/(deficits) in the 90s; similar approach taken by AB in 2013-14 & 2014-15.<br>• Given that capital expense is approximately $7B to $8B each year, this could result in a surplus and create room to fund additional priorities. | • The government could shift its fiscal anchor to focus on the net debt-to-GDP ratio rather than a surplus/(deficit).<br>• Would shift the narrative away from budget balance to a measure of longer-term fiscal sustainability.<br>• Subject to volatility, resulting from changes in economic growth, investments in capital, and shifts in accounting standards. | • The government could consider postponing balance to 2018-19 or a later fiscal year.<br>• Provides some flexibility in 2017-18 but would still require significant fiscal effort to balance by 2018-19.<br>• May be scrutinized by stakeholders (e.g. rating agencies) for moving off of targets that were originally set out in 2010 and reinforced thereafter.<br>• If the government continues to run deficits, a recovery plan would be required. |

TO BE UPDATED

# Asset Optimization Scenario: Acceleration of Hydro One Share Sales to 2017-18

| $ Millions | Current Outlook 16-17 | 17-18 | 18-19 |
|---|---|---|---|
| **Asset Optimization (AO) Outlook** | **685** | **695** | **170** |
| **Changes since 2016 Budget** | | | |
| Hydro One Sale | *20* | *(335)* | *(305)* |
| Hydro One Brampton | *(70)* | *(5)* | *(5)* |
| LCBO Head Office Lands | *50* | - | - |
| OPG Headquarters and Parking Garage | - | *(5)* | - |
| Seaton Lands | *(70)* | *40* | - |
| Lakeview Lands | - | *(20)* | - |
| **Total Asset Optimization Variance** | **(75)** | **(325)** | **(305)** |
| **Revised AO Outlook since 2016 Budget*** | **610** | **370** | **(135)** |
| Accelerate Sale of Hydro One Shares to 2017-18 | - | *235* | *(265)* |
| **Revised AO Outlook*** | **610** | **605** | **(410)** |

**Hydro One impacts include the following assumed IOD savings: $115 M in 2016-17 / $197 M in 2017-18 / $221 M in 2018-19 that are subject to reporting reclassification. Numbers are rounded to the nearest $5M and may not add due to rounding. All asset optimization values are subject to market conditions, and with increased uncertainty in out years.*

Scenario

- Acceleration of sale of Hydro One shares in 2017-18 (~25% of common shares are sold in 2017-18) would result in:
  - An offset against negative AO variance in 2017-18
  - A lower 2017-18 AO outlook than the 2016 Budget (by $90M, as a result of recent low share prices).
  - Maintaining provincial ownership of at least 40% of Hydro One (5% of shares would be kept as a cushion to do so)
  - No available shares for sale in 2018-19 (because 5% buffer of shares was kept).
    - This would have a negative impact of ~$685M in 2018-19
- Potential downward pressure on market prices and upward pressure on sale discount or fees
  - A high volume of shares sold at once / in one year, can further lower realised gains on sale.

Assumptions

- All estimates are subject to a number of factors, most notably the market price of Hydro One shares and the per cent of shares sold.
- Other risks include market risk, interest rate environment, OEB regulatory decisions, and impact of any Hydro One acquisition activities.

# Tools Included in the 2016 Budget

| $ Billions | 2017-18 | 2018-19 | Risk Assessment | Timing of Outcome/Decision |
|---|---|---|---|---|
| **Prudence** | 0.1 | n/a | Low | n/a |
| Reduced the reserve from $1.2 billion to $1.1 billion in 2017-18. 2018-19 reserve of $1.2 billion was unchanged. | | | | |
| **Cap and Trade** | 0.6 | 0.6 | Low – 2017-18<br>High – 2018-19 | 2017 Doc/<br>March Auction |
| Impact of a strategy that meets the government's climate change objectives while providing a benefit to the fiscal plan by funding $0.6B in plan projects annually with projected Cap and Trade proceeds. | | | | |
| **Other Revenue Measures** | 0.1 | 0.2 | Low | Implemented |
| Tobacco tax increase of $3/carton in 2016-17 and indexation thereafter, and the wine strategy. | | | | |
| **Re-profile Asset Optimization Strategy** | 0.3 | [redacted] | Low | Pending |
| Strategy assumed sale of OPG headquarters was delayed from 2016-17 to 2017-18. | | | | |
| [redacted] | [redacted] | 1.3 | High | Dec 2016 FMM/<br>2017 Fed Budget |
| Assumed a potential impact of $1.0 billion in each of 2017-18 and 2018-19 in unconditional infrastructure funding in each year (for in-plan projects). In addition, per-capita homecare and jobs and training funding in each fiscal year (applied to existing spending). | | | | |
| **Update Interest on Debt Outlook** | 0.3 | 0.4 | Low | Jan/Feb 2017 |
| Revised IOD outlook, reflecting updated interest rate forecasts. | | | | |
| **Key Tools Included in the 2016 Budget Fiscal Outlook** | 2.6 | 2.5 | | |

**Risk Assessment**

| | |
|---|---|
| **Low** | Tool is likely to fully materialize |
| **Medium** | There is some uncertainty whether the tool will fully materialize |
| **High** | Significant uncertainty whether the tool will fully materialize |

[redacted]

# Assumptions and Tools Included in the 2016 FES

| $ Billions | 2017-18 | 2018-19 | Risk Assessment | Timing of Outcome/Decision |
|---|---|---|---|---|
| [redacted] | [redacted] 2017-18 | | | |
| [redacted] | [redacted] | [redacted] | | |
| The FES included more aggressive forecasts for economic growth, federal transfers, and non-tax revenues. | | | | |
| *Taxation* | | | | |
| *CIT Revenue Yield* | *0.5* | *0.7* | **High** | **2017-18 Pub. Accts.** |
| *HST higher revenues* | *0.3* | *0.3* | **Low** | **December 2016** |
| *Federal Transfers (unconditional)* | *0.7* | *1.5* | **High** | **Dec 2016 FMM/ 2017 Fed Budget** |
| *Government Business Enterprises* | *0.2* | *0.2* | **Medium** | **Dec – Jan** |
| *Other Non-tax Revenue* | *0.1* | *0.1* | **Low** | **2017-18 Pub. Accts.** |
| **Prudence** | **1.2** | **1.2** | **High** | **n/a** |
| The Contingency Funds were drawn down by $0.6 billion in 2017-18 and 2018-19; the Year-End Savings Targets were increased by $0.2 billion in each year, and the Reserve was reduced by $0.4 billion in both years. | | | | |
| **Interest on Debt** [redacted] | **0.8** | **0.7** | **Medium** | **Jan/Feb 2017** |
| The FES outlook included a significant increase to estimated interest on debt savings. | | | | |
| [redacted] **Fiscal Outlook** [redacted] | [redacted] | [redacted] | | |
| **Other Revenue assumptions: PIT carry forward** | **0.6** | **0.6** | **Medium** | **June-Dec 2017** |

**Risk Assessment**

**Low** Tool is likely to fully materialize

**Medium** There is some uncertainty whether the tool will fully materialize

**High** Significant uncertainty whether the tool will fully materialize