#1 MEILLEUR PRÉVISIONNISTE GLOBAL – CANADA
FOCUS ECONOMICS
ANALYST FORECAST AWARDS
2022
#1 BEST OVERALL FORECASTER – CANADA

ECONOMIC VIEWPOINT

A Pivotal Budget for Alberta

What to Watch in Alberta's 2023–2024 Budget

By Marc Desormeaux, Principal Economist, and Marc-Antoine Dumont, Economist

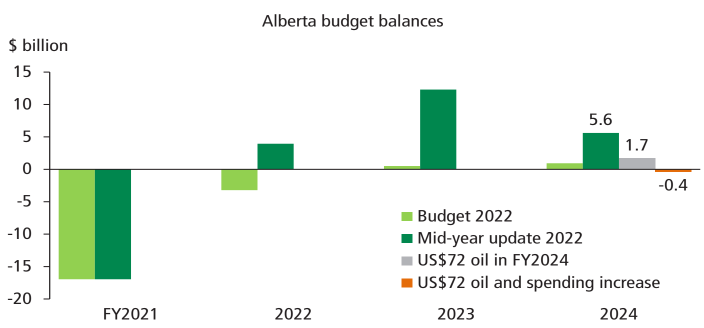
- Alberta's fiscal year 2023–2024 (FY2024) budget, set for release on February 28, is a pivotal moment in the province's fiscal history.
- Alberta's economic prospects and public debt metrics are the envy of the provinces, and we think continued forecasts of strong surpluses are the most likely outcome of the coming budget. But we also see downside risk to its budget balances this year.
- Oil prices are currently high enough to support a record surplus this fiscal year and a $5B+ surplus in the coming fiscal year. But a historically high dependence on crude prices means outsized revenue losses if forecasts prove too optimistic. In a conceivable downside West Texas Intermediate (WTI) scenario, we estimate that the FY2024 bottom line would be almost $4B weaker than assumed in the November 2022 update.
- Last year's ministerial mandate letters also suggest program spending increases could erode up to $2.1B from the bottom line in FY2024 (graph 1).
- In a high-risk economic and fiscal environment, we think Alberta should be as prudent as possible with its expenditures and continue to prioritize repaying outstanding debt.
- It would also be wise to signal support for the renewable energy industry—in collaboration with the federal government—given competitiveness challenges presented by measures in the US Inflation Reduction Act.

Introduction

What a (fiscal) year it's been for Alberta! Just 12 months ago, the oil-rich province was fresh off its deepest-ever recorded deficit and was expecting a combined shortfall of more than $11B over the ensuing three years. Budget 2022, released as Russia's invasion of Ukraine drove crude values sky-high, forecast slim surpluses through FY2025. But after several months of oil prices over US$100/barrel, the province projected an all-time high surplus in FY2023 and near-record surpluses in the following two years. Now, after a gusher of royalty revenues and success on spending control, Alberta arguably has the strongest public finances of any Canadian province.

Despite such a remarkable turnaround, there are downside risks coming into this budget. Crude values are high enough to support a strong surplus in FY2024, but myriad economic and geopolitical risks loom. The structure of Alberta's royalty

GRAPH 1
It Won't Take Much to Eliminate Alberta's FY2024 Surplus



Sources: Alberta Treasury Board and Finance and Desjardins Economic Studies regime means outsized revenue losses if crude underperforms expectations. New spending could be on the way. And economic diversification remains a key question as the climate transition progresses. Against that backdrop, we argue that the province should remain prudent with its expenditures for now, despite fiscal room and the typical pre-election political pressures.

Weaker Alberta Oil Prices = Weaker but Still-Record Surplus

Since the November 2022 mid-year fiscal update, WTI prices have cooled to the US$75–$80/barrel range as expected. With less than two months left this fiscal year, it's unlikely that the annual average will greatly deviate from November's US$91.50 forecast. That provides the foundation for FY2023 non-renewable resource receipts to come in near a projected high of $28.1B, anchoring a record surplus.

Yet persistent Western Canadian Select (WCS) price weakness at the end of the fiscal year should eat into the bottom line. Amid temporary refinery shutdowns and abundant heavy oil supply, the WCS–WTI spread has averaged about US$2/barrel more than the US$19.80 last forecast for FY2023. Alberta's own fiscal sensitivity estimates suggest that such a shortfall in oil prices will lead to over $800M in lost revenues. The good news: recovering refinery activity has helped tighten spreads more recently, and Alberta's FY2023 surplus would still come in at a record of more than $11B in all WCS scenarios we ran (table 1).

TABLE 1
The WCS–WTI Discount Will Chip Away at the Record Surplus in FY2023

	WCS–WTI discount (US$/barrel)		Budget balance ($M)	
	Rest of year	Full fiscal year	WCS–WTI impact*	New projection
Alberta government projection	—	**19.80**	—	**12,294**
Discount maintains YTD average	21.59	**21.59**	-823	**11,471**
Desjardins forecast, Feb. 2023	—	**20.85**	-483	**11,811**
US$10/barrel rest of year	10	**20.85**	-482	**11,812**
US$18/barrel rest of year	18	**21.36**	-718	**11,576**
US$25/barrel rest of year	25	**21.81**	-924	**11,370**

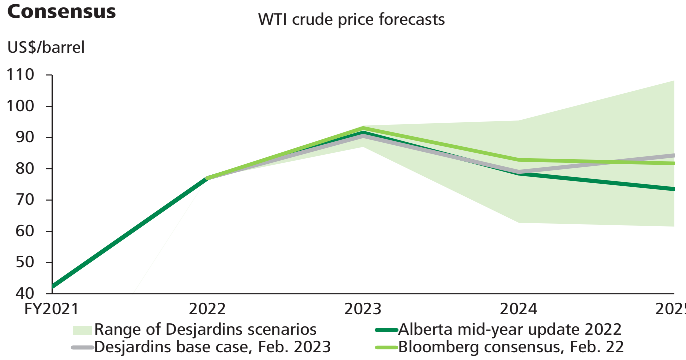
* Assuming C$460 million per US$1/barrel WCS–WTI discount, per Alberta Budget 2022
Sources: Bloomberg, Alberta Treasury Board and Finance and Desjardins Economic Studies

Non-resource revenue looks to be tracking largely in line with projections in the mid-year update. Stronger-than-expected primary household income growth to date should be eroded by a slightly stronger exchange rate versus the US dollar.

Historically High Stakes for Oil Price Forecasts

While Alberta's latest forecasts align well with consensus forecasts (graph 2), the fiscal outlook is far from certain.

GRAPH 2
The Latest Alberta Oil Price Projections Are Still in Line with the Consensus



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

For one thing, myriad economic and geopolitical risks could move prices lower this year. These include weakening demand due to a global recession and developments in the Russia–Ukraine war and diplomatic tensions between China and the US.

There is also risk related to the structure of Alberta's royalty regime. In FY2024, the fiscal sensitivity of WTI and the WCS–WTI discount will likely surpass this year's record highs, which means outsized revenue losses if crude prices underperform projections. This assumes that more oil sands projects reach post-payout status and that Alberta production increasingly tilts towards heavy sour crude. We noted this dynamic in [Seven Burning Questions on Alberta's Finances.]

We ran five scenarios with the assumption that WTI fiscal sensitivity will hit a record C$600M/barrel this fiscal year. That is slightly less than the implied oil price sensitivities from high- and low-crude value scenarios published in Alberta's FY2023 mid-year update. On that basis, WTI only has to fall to about US$70/barrel this year to unwind the provincial surplus. Of course, potential upside naturally raises the possibility of another windfall (table 2).

TABLE 2
FY2024 WTI Price Arithmetic for Alberta's Budget

	WTI price (US$/barrel)	Budget balance ($M)	
		WTI impact*	New projection
Alberta government projection	**78.50**	—	**5,615**
Desjardins base case, Feb. 2023	**78.42**	-50	**5,565**
Desjardins bearish scenario	**64.50**	-8,353	**-2,738**
Desjardins bullish scenario	**95.00**	+9,889	**15,504**
US$75/barrel	**75.00**	-2,100	**3,515**
US$72/barrel	**72.00**	-3,900	**1,715**
US$70/barrel	**70.00**	-5,100	**515**

* Assuming C$600 million per US$1/barrel WTI
Sources: Bloomberg, Alberta Treasury Board and Finance and Desjardins Economic Studies

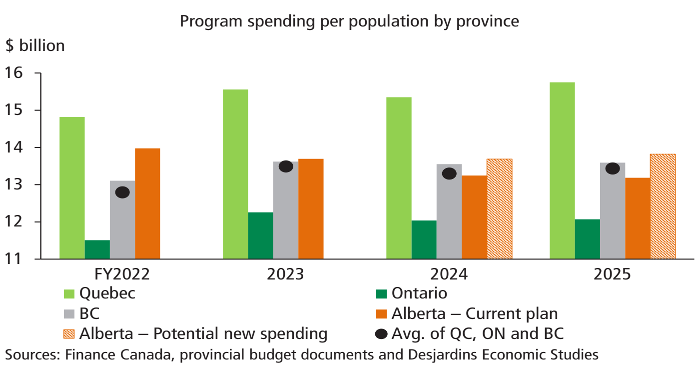
We don't think a low-70s average for WTI is highly likely this year, but it's certainly possible. It could come via weaker-than-forecast global economic growth or higher-than-expected oil production, mainly from non-Russian producers, that brings the market into surplus. Either factor could depress oil prices on its own, but it would most likely be a combination of the two that would result in a US$70/barrel average. To be clear, such a price likely would not weigh significantly more on oil and gas sector activity or profitability than crude nearer to $US80/barrel would. The point is that in the current context, even small crude price movements have major implications for government revenues.

Mandate Letters and a Looming Election Imply Spending Boost

While oil prices present revenue downside, last year's ministerial mandate letters lay the groundwork for more spending. Notes to the minister of finance included an operational spending cap equal to the rate of inflation plus population growth in Budget 2023. Based on the latest 2023 government forecasts for those variables, operational expenses could thus climb by as much as 5.5% in FY2024, $2.1B more than forecast in November. And with the cost of living still rising rapidly and an election around the corner, the incentive to offer "goodies" is clear.

Assuming current fiscal anchors are upheld, Alberta wouldn't have much room to loosen the purse strings. The previous administration aimed to align per-person program spending with that of the other three large provinces. The current government maintained that anchor at mid-year and was on track to beat the three-province mean in FY2024 (graph 3). If it wants to stick to that target, Alberta can only raise program spending by $250M in FY2024 and $1.2B in FY2025.

GRAPH 3
Potential New Spending Could Mean Missing Current Targets



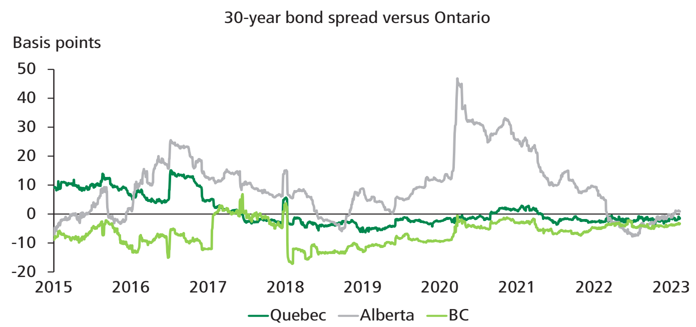
Sources: Finance Canada, provincial budget documents and Desjardins Economic Studies

The province could manage these constraints in a few ways. It could delay the target until FY2025 or later, when other provinces' plans and the impacts of rapidly rising interest rates are clearer. It may also suspend the anchor on the grounds that economic support or healthcare capacity upgrades are needed now. On that front, the new federal–provincial healthcare agreement should help offset any pressure on deficits and debt created by new provincial spending. Still, deviating too much from the current spending target risks undoing a policy success cited by multiple rating agencies and impacting long-run fiscal sustainability.

Bond Spreads Appear to Have Priced in Some Downside

Markets seem to be pricing in some downside risk related to Alberta's finances. The province's 30-year bond yields have exceeded Ontario's since mid-January—the first time since before Russia invaded Ukraine (graph 4). Ten-year bond spreads have also widened versus Ontario in recent weeks. Some of that movement surely reflects the downward trend in WTI observed in the past few months. However, long-dated Alberta bonds are still trading tighter to Ontario than they did after the last pre-pandemic commodity price correction. That suggests that at least some of the recent fiscal improvement is expected to persist.

GRAPH 4
Alberta Bonds Are No Longer Trading through Ontario



Sources: Bloomberg and Desjardins Economic Studies

We think there is some scope for spread movement in the aftermath of the budget's release. That movement likely won't be as significant as the 4bps tightening relative to Ontario we saw after the July 2022 Public Accounts reported a surprise surplus in Wild Rose Country in FY2022. But a weaker financial outlook could drive more incremental Alberta yield movements versus other provinces, like those witnessed after the mid-year update penciled in multibillion-dollar surpluses through FY2025.

Prudent, Targeted Spending Plans

Acknowledging a Canada-wide need for increases in healthcare capacity, we think Alberta should be as prudent and targeted as possible with its expenditures in this budget. As we noted in our Desjardins Provincial Outlook: Housing versus Commodities, Alberta's economy looks reasonably well-insulated from the coming economic downturn. And in For Canada's Newest Immigrants, The West Is Best, we explained why Alberta is arguably the province mostly likely to benefit from the newest wave of immigration. It has already taken steps to expand economic opportunities in sectors ranging from petrochemicals manufacturing to technology to agriculture, which need time to bear fruit. Now doesn't appear to be the best time to introduce new, potentially inflationary spending.

We do think the government can help to provide more certainty on support for the renewable energy sector. Alberta's mid-year update stated that non-energy business investment will "be buoyed by large-scale projects in clean technology, renewable power and other emerging sectors." It further forecast that non-energy capital outlays would outpace those related to energy through 2025. Still, lack of regulatory certainty remains a key barrier to investment, particularly following significant new incentives and momentum in the sector south of the border. Alberta can assuage some of these concerns with a clear signal that it will collaborate with Ottawa to respond to US measures.

Final Thoughts

Alberta is in an enviable fiscal position relative to other Canadian provinces, and we think continued forecasts of strong surpluses are the most likely outcome of the coming budget. Yet, while it has mounted a truly remarkable turnaround, it faces real downside risks. Against that backdrop, the province can and should keep its proverbial powder dry despite the perennial political pressures that come with revenue windfalls. That will allow it to plug any budgetary holes that arise, make progress on fiscal sustainability objectives and expand economic opportunity for all Albertans, not just in FY2024 but for many fiscal years to come.