Special Review of the Financial Condition of

The Province of Newfoundland and Labrador

Directions, Choices and Tough Choices

December 22, 2003

PricewaterhouseCoopers

PricewaterhouseCoopers LLP
Atlantic Place, Suite 802
215 Water Street, Box 75
St.John's, NL
Canada A1C 6C9
Telephone +1 (709) 722 3883
Facsimile +1 (709) 722 1428

Minister of Finance
President of Treasury Board
Government of Newfoundland and Labrador
P.O. Box 8700
St. John's, NL
A1B 4J6

December 22, 2003

Special Review – Financial Condition of the Province of Newfoundland & Labrador

We are pleased to present to you the Special Review of the Province's Financial Condition. We have carried out the Review in accordance with the terms of reference pursuant to Paragraph 3 of the Request for Proposal Document dated November 7, 2003. The results of the Special Review are as follows:

- The Special Review has found that the 2003-04 fiscal targets i.e. the accrual deficit target of $665.9 million and the all entities cash deficit target of $286.6 million as outlined in the 2003-04 Budget have to be revised upwards to $827.2 million and $506.6 million respectively to reflect:
    - The $220 million cost on a cash basis of purchasing the Student Loan Portfolio – a decision taken post-budget, and
    - The $93 million estimated additional cost on an accrual basis of retirement benefits incurred for group health and life insurance

- A preliminary estimate suggests that the unrecorded liability for retirement benefits for group health and life insurance is in the order of $1.223 billion and that an annual accrual in excess of $100 million will be required in the future.

- The 2003-04 Budget did not contemplate having to finance the purchase of the student loan portfolio valued at $220 million from the current funder.

- The Special Review has found that the current and capital account budgets cannot be balanced by 2007-08 with revenue growth (alone).

- On the basis of these revised projections and supporting detailed information and in particular due to the acquisition of the Student Loan portfolio the Special Review finds that the 2003-04 fiscal targets outlined in the Budget no longer remain realistic and attainable.

We would like to thank you for the opportunity to carry out this review. We trust that you will find it helpful as you prepare for the development of the Province's budgets and future fiscal plans.

In addition, we would like to thank you and your staff for the fine co-operation and assistance of all of the Ministries, agencies and Crown corporation staff who provided prompt and professional assistance in carrying out the analysis and data collection so critical to completing the Special Review on time.

We are of course prepared to meet to discuss the Report at your convenience.

Yours truly,

PricewaterhouseCoopers LLP

St. John's, Canada

Table of Contents

List of Appendices

1.0 Introduction

PricewaterhouseCoopers LLP (PwC) was engaged by the Province of Newfoundland and Labrador (the Province) to conduct a Special Review of the Province's Financial Condition (the Special Review).

The scope of the Special Review is described in detail in the next section.

The Special Review was carried out in a manner respecting the Terms of Reference specified in the Request for Proposal Dated November 7, 2003.

In certain instances it was necessary to request additional information and analysis to ensure a complete understanding of issues. In other instances it was necessary to request the staff of the Department of Finance and the Treasury Board to provide preliminary or rough estimates in order to set an appropriate context for an issue. In each case where these preliminary or rough estimates are used the Special Review clearly identifies the nature of the estimates. Furthermore the Special Review has been assured that those estimates will be refined over the next few months to ensure that the Government is able to make decisions based on more complete estimates.

Before proceeding with the balance of this Report, readers should be aware of certain cautions that must be taken into account when considering the findings of the Special Review.

In the first instance, the financial and all other related information contained herein was provided to the Special Review by the Province. Staff of the Department of Finance and the Treasury Board Secretariat were very helpful and thorough in providing information and in preparing analytical reports in support of the Special Review. They have provided written assurance that all issues relating to the Special Review's task have been identified and that all data and information is accurate and complete. (See Letter Appendix 7) The Province therefore has the responsibility for its accuracy or completeness. For this reason, PwC expresses no opinion and provides no assurance on the financial information contained in this report.

The findings of our Special Review are contained herein.

It should also be understood that this Special Review, as specified by the Request for Proposal, is not an audit or review engagement as defined by the Handbook of the Canadian Institute of Chartered Accountants.

The Special Review consisted primarily of interviews, document review and analysis and discussions and as such, we have made no attempt to assess the financial viability of any individual entity. We made inquiries of senior officials of Treasury Board Secretariat and Department of Finance as to the financial condition of government agencies and have relied on those discussions.

1.1 Terms of Reference

The terms of reference of the Special Review were specified in the Request for Proposal, dated November 7, 2003.

Those terms of reference required the Special Review to focus on:

- Whether or not the 2003-04 fiscal targets outlined in the Budget remain realistic and attainable.
- Whether or not, based on the assumptions (outlined below), the current and capital account cash budget can be balanced by 2007-08

The Special Review was intended to serve to ascertain the financial condition of the Province and base its findings on a review of:

- Fiscal 2003-04
  - Budget Estimates;
  - Revenues, Expenditures and Commitments;
  - Revenue and Expenditure forecasts: and
  - Economic Forecasts

- Fiscal 2004-05 to 2007-08
  - The Process used to determine future years' projections;
  - The validity of the assumptions used in developing the projections; and
  - The reasonableness of the projected revenue and expenditures.

The initial results of the Special Review were to be provided to the Minister of Finance and President of Treasury Board by the close of business November 28, 2003, with a final report to be provided by December 15, 2003. Delivery of the Final Report was delayed to permit the incorporation of the November 2003 budget performance reports and to permit the inclusion of a more refined estimate of the cost of the post retirement benefits costs associated with group health and life insurance benefits.

It is understood that the results of the Special Review will be made public.

1.2 Summary Findings

2003-04 Findings

The original consolidated accrual based deficit of $665.9 million is now revised and estimated to be $161.3 million higher projected at $827.2 million for the fiscal year ended March 31, 2004. This revision represents an increase of 24.2% from the original budget.

The Special Review has found that the 2003-04 fiscal targets, i.e. the accrual deficit target of $665.9 million and the all entities cash deficit target of $286.6 million as outlined in the 2003-04 Budget, have to be revised upwards to $827.2 million and $506.6 million respectively to reflect:

- The $220 million cost of purchasing the Student Loan Portfolio – a decision taken post-budget, and
- The $93 million estimated additional cost on an accrual basis of retirement benefits incurred for group health and life insurance

The cost of retirement benefits is a recent issue recommended by the Public Sector Accounting Board (PSAB) of the Canadian Institute for Chartered Accountants which sets financial reporting standards for all federal and provincial jurisdictions throughout Canada. PSAB has recommended that retirement benefits for group health and life insurance be accounted for on the accrual basis rather then the cash basis. Jurisdictions must have an actuarial determined cost and liability recorded by 2005. An estimate of the cost for future benefits was not available for inclusion in the budget. An actuarial review has been underway for several months and the projected deficit included in this report on an accrual basis includes a provision of $93 million as a preliminary estimate of those costs.

The 2003-04 Budget did not contemplate having to finance the purchase of the student loan portfolio from the current funder. The current funder had notified the Government that it would no longer operate and fund the student loan portfolio. At Budget time it was expected that through a competitive Request for Proposal Process (RFP) a more cost effective alternative funder and provider could be found. The RFP process was carried out. However, no cost effective alternate was provided. As a result, the Government must take over the funding of the Student aid portfolio and options are currently being reviewed. This action imposes a one-time increase in the "cash deficit" of $220 million bringing the total projected "cash deficit" to $506.6 million for the year 2003-04.

The Budget Outlook has been updated to reflect favourable and unfavourable variances. For the time being these would appear to be offsetting. However this projection is based on there being no further unfavourable variances that could not be offset by favourable variances over the remaining four and one half months of the fiscal year. Excluding the decision on the funding of the student loan portfolio, and in view of the:

- breadth of the Province's responsibilities;
- past experience; and
- the fact that there are no remaining meaningful contingencies or reserves that have not been allocated for other purposes.

Despite these factors, staff of the Department of Finance and the Treasury Board Secretariat are satisfied, except for the student loan issue, that it can manage the revised cash deficit target of $506.6 million.

Given this situation it is difficult to predict precisely at this time what the actual deficit at the end of the year will be for the fiscal year 2003-04, which ends on March 31, 2004.

- On the basis of these revised projections and supporting detailed information and in particular due to the acquisition of the Student Loan portfolio the Special Review finds that the 2003-04 fiscal targets outlined in the Budget no longer remain realistic and attainable.

The Table below illustrates the projected results for 2003-04 in summary form.

(Table 1)

Consolidated Accrual Budget				
Original Budget and Projected Revised - 2003-04				
	Original Budget 2003-04	**Projected Revised 2003-04**	**Positive (Negative) Variance**	
	$ millions	**$ millions**	**$ millions**	**% Variance**
Federal Provincial Revenues	3,688.2	3,728.2	40.0	1.1%
Expenditures, net of related revenues	3,900.9	3,940.9	(40.0)	-1.0%
Adjust: Student aid loans		220.0	(220.0)	
Cash – Based deficit – Consolidated Revenue Fund	**212.7**	**432.7**	**(220.0)**	**(100.3%)**
Borrowing requirements of other entities	73.9	73.9		0.0%
Adjusted Budgetary Borrowing Requirements - All entities	**286.6**	**506.6**	**(220.0)**	**-76.8%**
Accrual adjustments:				
Student aid receivable		(220.0)	220.0	100.0%
Bad debt expense - Student aid		55.0	(55.0)	100.0%
Pension interest and accrued pension cost, net of cash contributions	301.9	335.9	(34.0)	-11.3%
Retirement benefits expense for health and life insurance		93.0	(93.0)	100.0%
Other amounts	54.5	44.0	10.5	19.3%
Other entities	24.1	21.4	2.7	11.2%
Tangible Capital Assets-reverse additions, record depreciation	(1.2)	(8.7)	7.5	-625.0%
Accrual - Based deficit - Consolidated Summary	**665.9**	**827.2**	**(161.3)**	**-24.2%**
Source: Department of Finance and Treasury Board Secretariat				

Four year period to 2007-08

The Special Review has found that the current and capital account budget <u>cannot</u> be balanced by 2007-08 with revenue growth (alone).

The Special Review examined projections of expenditure and revenue that have been prepared by the Department of Finance and Treasury Board Secretariat that reflect the continued strong economic growth of the Province of Newfoundland and Labrador over the four year period to 2007-08, as provided in the following table:

(Table 2)

Projected Consolidated Accrual Deficit, Cash Deficit and Net Debt						
($ millions)						
	Original	**Revised**				
	2003-04	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
	(budget)	**(proforma)**	**(projection)**	**(projection)**	**(projection)**	**(projection)**
Revenue	4,347.0	4,352.4	4,207.9	4,221.6	4,392.5	4,516.4
Expenditures	5,012.9	5,179.6	5,196.8	5,334.9	5,516.0	5,672.3
Deficit, (accrual basis)	665.9	827.2	988.9	1,113.3	1,123.5	1,155.9
Net Debt		11,587.3	12,574.7	13,630.6	14,695.4	15,796.3
Cash Deficit	286.6	506.6	601.6	672.8	665.4	710.8
Source: Department of Finance and Treasury Board Secretariat, November 2003.						

The 2003 Budget Speech statement "...revenue growth could account for all of the fiscal improvement needed to eliminate the deficit, and more." can no longer be supported. For the five year period the above table indicates that the annual cash deficit (operating or current and capital accounts deficit) ranges from a minimum of $506.6 million for 2003-04 to $710.8 million for 2007-08.

The Table also shows that current projections for revenue growth on the Consolidated Accrual basis increase by $164.0 million in 2007-08 compared to estimates for 2003-04. This is comprised of an increase of $314 million in provincial-federal revenues and a decrease of $150 million in program related revenues. Even if the $150 million reduction in related revenues is offset by a corresponding reduction in program expenditures, the increase of $314 million in provincial-federal revenues will not be sufficient to eliminate that deficit by 2007-08.

The projection for revenue growth includes forecast growth in oil related revenue, consisting of royalties and corporate income tax, from a forecast $160.1 million in 2003-04 to $491.9 million in 2007-08.

Offsetting the growth in Provincial revenues is a forecast decline in Federal transfers. Based on existing programs for equalization, Canada Health and Social Transfers (CHST) and the Atlantic Accord protection regarding offshore oil revenues, the Province's Finance Department estimates the Federal transfers to the Province in 2007-08 fall to $1.180 billion from the 2003-04 estimate of $1.444 billion. As a measure of relative importance to the Province a chart provided in section 4.0 "Financial Condition Review" shows Federal transfers as % of Provincial Revenue declining from 62.75% in 2003-04 to 42.38% in 2007-08.

The result of the forecast limited growth in total revenue and conservative increases in expenditure is forecast cash deficits (the lowest possible measure of deficit) for the period to 2007-08 ranging from $506.6 million to $710.8 million each year. More importantly an accrual deficit in excess of $1 billion dollars per year will be incurred if no actions are taken over the period, in spite of the strong economic outlook facing the Province.

Government needs to develop and implement clear and decisive action plans to address the fiscal imbalance and to avert those forecast record levels of deficit for each and every year over the next four years. Clearly the Government, its employees and everyone in Newfoundland and Labrador will have to focus on dealing with this situation.

Four years of projected cash deficits of a record average of more than $600 million per year, and with accrual deficits averaging approximately $1 billion suggest a longer rather than a shorter term resolution of the underlying fiscal imbalance.

There are a number of specific issues and findings that are discussed in detail in the balance of the report. They include:

- The Deficit
- Public Sector Pension Plan Funding Levels
- Retirement benefits Cost and Funding
- Hospital Funding
- Education Funding
- Student Loan Portfolio Purchase Financing
- Pay Equity Contingent Liability
- Provincial Debt

The Special Review also considered the financial indicators included in the Auditor General's report related to "sustainability", "vulnerability" and "flexibility". Those indicators are often used to assess a government's financial health in the context of the overall economic and financial environment. Also considered were the financial indicators contained in the Treasury Board Secretariat document entitled "Understanding the Financial Health of the Province".

1.3 Methodology

The Special Review could not have been completed in time without the prompt, courteous and professional cooperation of the Deputy Ministers and senior staff of the Province of Newfoundland and Labrador. The Special Review had face to face meetings with more than 68 senior staff. Many attended several meetings to ensure that the Special Review had the full benefit of their understanding and insight into the budgetary, fiscal management, accounting and economic issues under review.

The Special Review included an examination and review of more than 950 documents. Attached, as Appendix 1, is a listing of the principal documents which were reviewed in depth.

Whenever new analyses or new data were required, requests were made of staff and these were invariably provided the same business day or on the morning of the next day. The Special Review received the fullest cooperation throughout the entire review period.

The Province provided appropriate meeting space and support staff to assist the Special Review. This enabled the vast majority of the work and all of the meetings to take place in the Offices of the Department of Finance and Treasury Board Secretariat.

1.4 Auditor General's Report

The Special Review had available the report of the Auditor General on the Financial Statements of the Province of Newfoundland and Labrador for the year ended March 31, 2003. The Special Review did not consider the Auditor General's Report to the House of Assembly on Reviews of Departments and Crown Agencies which was released on December 16, 2003, in particular, the Special Review did not consider the fiscal impact of the cost of compliance for issues raised in the Report due to a lack of sufficient time.

2.0 Current Fiscal Year 2003-04

The Special Review examined and assessed the current projection of $827.2 million for the accrual deficit (a projected 24.2% increase of $161.3 million) and revised cash deficit projection of $506.6 (an increase of $220.0 million). **On the basis of these revised projections and supporting detailed information, the Special Review finds that the 2003-04 fiscal targets outlined in the Budget are no longer realistic and attainable.**

The 2003-04 Budget did not contemplate having to finance the purchase of the Student Loan Portfolio from the current funder. The current funder had notified the Government that it will no longer operate and fund the student loan portfolio. At Budget time it was expected that through a competitive request for proposal process a more cost effective alternative funder and service provider could be found. The request for proposals process was carried out but no cost effective alternate provider was found. As a result, Government decided in August of 2003 to take over the operation and is currently exploring its options surrounding management of the portfolio. This action will add a one-time increase in the "cash deficit" of $220 million for the purchase of the Student Loans Portfolio asset bringing the total projected "cash deficit" to $506.6 million for the fiscal year 2003-04.

The 2003/04 Budget did not reflect a provision for the cost of retirement benefits for group health and life insurance. New Public Sector Accounting Board guidelines recommend that accrued retirement benefits be recorded. Some Provinces have already included this accrual in their expenditures and other Provinces are in the process of doing so. In Newfoundland and Labrador actuaries have been hired to determine the estimated liability and annual ongoing costs. As reasonable estimates have recently been provided Government has decided to include this cost in fiscal 2003-04. The projected accrual deficit includes a provision of $93 million as a preliminary estimate of those costs. There are 43,000 employees including 13,000 retirees in the group health and life insurance plans. A reasonable estimate was not available at budget time.

(Table 3)

Consolidated Accrual Budget				
Original Budget and Projected Revised - 2003-04				
	Original Budget 2003-04	**Projected Revised 2003-04**	**Positive (Negative) Variance**	
	$ millions	**$ millions**	**$ millions**	**% Variance**
Federal Provincial Revenues	3,688.2	3,728.2	40.0	1.1%
Expenditures, net of related revenues	3,900.9	3,940.9	(40.0)	-1.0%
Adjust: Student aid loans		220.0	(220.0)	
Cash – Based deficit – Consolidated Revenue Fund	212.7	432.7	(220.0)	(100.3%)
Borrowing requirements of other entities	73.9	73.9		0.0%
Adjusted Budgetary Borrowing Requirements - All entities	**286.6**	**506.6**	**(220.0)**	**-76.8%**
Accrual adjustments:				
Student aid receivable		(220.0)	220.0	100.0%
Bad debt expense - Student aid		55.0	(55.0)	100.0%
Pension interest and accrued pension cost, net of cash contributions	301.9	335.9	(34.0)	-11.3%
Retirement benefits expense for health and life insurance		93.7	(93.0)	100.0%
Other amounts	54.5	44.0	10.5	19.3%
Other entities	24.1	21.4	2.7	11.2%
Tangible Capital Assets-reverse additions, record depreciation	(1.2)	(8.7)	7.5	-625.0%
Accrual - Based deficit - Consolidated Summary	**665.9**	**827.2**	**(161.3)**	**-24.2%**
Source: Department of Finance and Treasury Board Secretariat				

The revised budget outlook has been updated to reflect a number of favourable and unfavourable variances in revenue and program expenditure. For the time being these would appear to be offsetting. However this projection is based on there being no further unfavorable variances that could not be offset by favorable variances over the remaining four and one half months of the fiscal year.

The revised budget outlook also reflects the incorporation of:

- Updated forecasts for public sector wages
- Updated forecasts for public sector pensions
- Recognition of the liabilities of retirement benefits
- Purchase of the Student Loan Portfolio

Each of these items is described in more detail in related sections which follow.

2.0.1 Methodology

The Special Review examined the 2003-04 Budget Estimates as tabled in the Legislature on March 27, 2003

The 2003-04 Budget Revenue Estimates were reviewed along with the latest adjustments to those forecasts as provided by the Department of Finance and Treasury Board Secretariat. (See Table 5)

The 2003-04 Budget Expenditure Estimates were reviewed along with the latest adjustments to those forecasts as provided by the Department of Finance and Treasury Board Secretariat. The November 2003 Departmental Budget Monitoring reports, with October actual revenue and expenditure, were used as the primary basis for the review of the 2003-04 Expenditure Forecasts. (See Table 6)

In addition the interviews with senior departmental staff provided supplementary information and insight into the most recent forecasts. The final report of the Special Review is based on the November 2003 Departmental Budget Monitoring Reports and any major known adjustments since that time.

A number of commitments had been made subsequent to the 2003-04 Budget. Each of the specific post-budget expenditure commitments made by the previous administration were identified and included in the expenditure projections for 2003-04.

2.0.2 The Deficit

The issue of what constitutes the "real" deficit is one which has played itself out in debates across Canada. The Auditor General notes in his report that this debate has led to confusion. Fiscal 2003-04 is the first year that the Province's Budget is prepared on the same accrual accounting basis as its audited financial statements. It should be clear to all that the Province's Budget and its Consolidated Financial Statement have been prepared on the same basis and that the accrual deficit is THE DEFICIT. For this fiscal year (2003-04) the deficit for the Province of Newfoundland and Labrador is projected to be $827.2 million, some $161.3 million higher than originally projected in the Budget tabled in the House of Assembly on March 27, 2003.

While the "cash deficit" has traditionally been used as the primary measure of the Province's fiscal performance, it is clear from the PSAB recommendations sections 1000 to 1200 and from the Report of the Auditor General for the Year Ended March 31, 2003, dated November 15, 2003 and others that use of the accrual accounting based deficit measure is consistent with the general improvements in public accountability and transparency of reporting now being demanded of both public and private organizations and corporations throughout the world.

While the cash position of the Province remains an important measure, the primary focus for the longer term has to be on the accrual deficit. Balancing the cash deficit will, in the short term, assist in achieving the ultimate goal of restoring the Province's financial health.

Provinces will still report their cash position, however it is now one of several measures used. It remains central to the establishment of a Province's annual borrowing requirements and it still is watched carefully by investors and other capital market participants.

2.1 Fiscal Table

The table below provides a summary comparison of the Original Budget with the Current Projections for both Revenue and Expenditures based on information provided by the Department of Finance and Treasury Board Secretariat. Note that this table includes both the accrual deficit and the cash position ('deficit').

(Table 4)

Consolidated Accrued Budget				
Original Budget and Projected Revised - 2003-04				
	Original Budget 2003-04	**Projected Revised 2003-04**	**Positive (Negative) Variance**	
	$ millions	**$ millions**	**$ millions**	**% Variance**
Federal Provincial Revenues	3,688.2	3,728.2	40.0	1.1%
Expenditures, net of related revenues	3,900.9	3,940.9	(40.0)	-1.0%
Adjust: Student aid loans		220.0	(220.0)	
Cash Position (surplus/deficit)– Consolidated Revenue Fund	212.7	432.7	(220.0)	(100.3%)
Borrowing requirements of other entities	73.9	73.9		0.0%
Adjusted Budgetary Borrowing Requirements - All entities	**286.6**	**506.6**	**(220.0)**	**-76.8%**
Accrual adjustments:				
Student aid receivable		(220.0)	220.0	100.0%
Bad debt expense - student aid		55.0	(55.0)	100.0%
Pension interest and accrued pension cost, net of cash contributions	301.9	335.9	(34.0)	-11.3%
Retirement benefits expense for health and life insurance	0.0	93.0	(93.0)	100.0%
Other amounts	54.5	44.0	10.5	19.3%
Other entities	24.1	21.4	2.7	11.2%
Tangible Capital Assets-reverse additions, record depreciation	(1.2)	(8.7)	7.5	-625.0%
Accrual - based deficit - Consolidated Summary	**665.9**	**827.2**	**(161.3)**	**-24.2%**
Source: Department of Finance and Treasury Board Secretariat				

2.2 Federal – Provincial Revenues – cash basis

(Table 5)

Changes to 2003-04 revenue projections to date (Nov. 20, 2003)	
	$ millions
Increases in Provincial Revenues	24.2
Revised estimates regarding federal transfers	15.8
Total projected revenue increase compared to March Budget	**$40**
Source: Treasury Board Secretariat / Department of Finance	

2.3 Expenditures (net of Related Revenues) – cash basis

(Table 6)

Changes to expenditure projections	
	$ millions
Increases in expenditures (net of related revenues)	83.5
Decrease in expenditures (net of related revenues)	(43.5)
Increases in net expenditure variance, prior to student aid loan purchase	**40.0**
Purchase of student aid loans from current funder	220.0
Total projected expenditure increase compared to March Budget	**$260.0**
Source: Treasury Board Secretariat / Department of Finance	

The following is a summary of some items of interest:

2.3.1 Public Sector Salary and Wage Projections.

The 2001 negotiations added approximately $350M to the annual salary bill to Government.

Annual Cost of 2001 Salary Increases	$ millions
Salary and Benefit Increase	257.0
Physicians Settlement	54.0
Pension Indexing	20.0
Increased School year	8.0
Classification Reviews	6.0
Additional School Board Support Staff	5.0
TOTAL	350.0

Source: Treasury Board Secretariat/ Department of Finance

This is in addition to the $32M in classification reviews completed prior to 2001 negotiations. Also, as a result of the 2001 negotiations, an additional $20M is being borrowed annually to fund the pension liability for the Public Service Pension Plan

Public Sector wages, benefits and pensions (excluding interest on the unfunded liabilities) represent approximately 52% of the Provincial Budget. It is for this reason that public sector wage negotiations must be carried out in the context of their overall impact on the health of the Province's finances.

As provided by Treasury Board Secretariat, every 1% change in public sector wages in the Province is equal to $22 million change in expense per year.

2.3.2 Public Sector Pension Plans

There are four main defined benefit pension plans that cover public sector employees in the Province of Newfoundland and Labrador. They are:

Public Sector Group	Membership
The Public Service Pension Plan (PSPP)	37,000
The Teacher's Pension Plan (TPP)	12,100
The Uniformed Services Pension Plan (USPP)	1,200
The Members of the House of Assembly Pension Plan (MHAPP)	130
Total	**50,430**
Source: Treasury Board Secretariat	

Over the past several years, the Government has taken strategic initiatives to improve the funding of the pension benefits promised under the four main pension plans.

PSPP

The Public Service Pension Plan provides benefits for the majority of public employees and those of its Crown agencies. In 1997 contributions were increased and an annual $40 million special payment stream was implemented to reduce the past service liability; and in 2002, as a result of negotiations, the special payments were increased to $60 million per year.

TPP

The Teachers' Pension Plan is a negotiated plan and all modifications must have the consent of the NLTA. In 1998, the TPP was modified. These modifications included benefit reductions and contribution rate increases. In addition, Government commenced a special payment stream of $76 million annually to be paid into the TPP fund over a 13 year period. The combined efforts of benefit modifications, contribution increases and special payments were projected to extend the life of the TPP to 2014. **However, based on the asset values in the plan at December 31, 2002, following 2 years of negative investment returns, the TPP is now projected to be exhausted by 2013. The funded ratio of the plan has decreased from 30.8% in 2000 to 23.4% in 2002.**

Further changes are necessary if the TPP is to survive.

USPP

The Uniformed Services Pension Plan (USPP) is a relatively small plan, with only 1,200 members, covering police officers, correctional officers and certain firefighters of the St. John's Regional Fire Department. This plan is similar to the PSPP, with the exception that members, because of the public safety nature of their occupations, can retire after 25 years of service.

MHAPP

The Members of the House of Assembly Pension Plan (MHAPP) covers 130 active and retired MHAs.

Pooled Pension Fund

The four main pension plans contribute to the Province of Newfoundland and Labrador Pooled Pension Fund (Pooled Pension Fund) for investment purposes. In 2001, the Pension Investment Committee, consisting of representatives from all the stakeholders, established a new asset mix policy of 75% equity, 5% real estate and 20% fixed income securities. At the Special Review date, approximately 75% of the fund is invested in equities, 2% in real estate and 23% invested in fixed income securities.

A survey of five other provincial public sector plans in Canada shows that the asset mix in those plans ranged between 25% and 58% in equities with the balance in fixed income securities.

The Province's asset mix is very aggressive and very susceptible to the volatility of equity markets. However, the Special Review confirmed that the long-term actual rate of return to date exceeds the actuarial assumed rate of return.

As noted in the Auditor General's Report, the cost of the public sector pensions remains a major concern for the Province's future financial outlook.

The Province and its 50,000 pension plan members and their union representatives will have several choices to make to improve the funding necessary to meet the pension plan obligations. At present, $163.5 million, in total, is being paid annually by Government to support the four main plans. The actuaries have advised that if contribution increases, plan amendments, and special payments with a combined additional annual effective impact of $104 million are implemented and maintained, then all plans should be 80% funded by 2030.

With the record deficits projected for the Province from 2003-04 to 2007-08 it is clear that all participants in the pension plans have to contribute to the solution to make those plans more stable.

2.3.3 Retirement Benefits

The new PSAB guidelines recommend accrued retirement benefits be recorded. According to the Province's Comptroller General, some Provinces have already included this accrual in their expenditures and other Provinces are in the process of doing so.

The Province recently engaged actuaries to determine the estimated liability and annual ongoing costs. As reasonable estimates are available it has been has decided to include this cost in fiscal 2003-04.

A preliminary estimate suggests that the unrecorded liability for retirement benefits is in the area of $1.223 billion and that an annual accrual of $93 million or more will be required in the future.

It should be noted that this $93 million increase is over and above the approximately $9 million already included in the cash deficit.

2.3.4 Health Expenditures

Health operating expenditures accounted for 44.5% of every program dollar spent in 2003-04. Public sector expenditures on health were 11 per cent higher per capita than the Canadian average for 2002.

The discussions with Department of Health and Community Services focused on the need to provide more adequate funding for accumulated deficits of the Province's Institutional Health Boards that currently amount to $96 million, the increasing cost of drugs and the demand for new drugs, and the need for additional funding for repairs and maintenance of existing facilities.

2.3.5 Education

In spite of an enrolment decline of almost 26% since fiscal 1995-96, education funding per student has increased from $5,538 in 1995-96 to $7,688 in 2003-04 for a total increase of $2,150 per student or 38.8%.

The discussions with the Department of Education focused on the need to provide more adequate funding for: environmental remediation of aged fuel storage tanks and replacement of school buses; almost one third of the fleet will have to be replaced over the next three years. Increasing utility costs were also of concern.

2.3.6 Student Loan Program

The Province has been advised that the current provider of the Newfoundland and Labrador Student Loan Program is no longer willing to serve as the funder for the program effective March 31, 2004.

Subsequent to the budget process an extensive request for proposal process determined that it would not be cost effective to engage an alternate private sector provider to manage the program.

As a result the Province will be required to purchase the outstanding portfolio of loans. That portfolio is currently valued at $220 million. Based on discussions with staff in the Department of Finance, it is expected that this purchase will be funded through direct borrowing by the Province. The Province currently does not have this requirement built into its cash requirements, nor was it built into the original budgeted cash requirements since at budget time it was expected that the request for proposals process would yield an alternate private sector funder and provider of the program.

It is now projected that this one time purchase of the student loan portfolio will add $220 million to the projected cash deficit of $286.6 million bringing the total cash requirements for 2003-04 to $506.6 million. On an accrual basis, it has been estimated that a bad debt provision equal to 25% of the total portfolio will have to be taken to reflect the current default rate of the portfolio.

The Province plans to integrate the loan program with the Federal Government and as a result will be using the Federal Government's service provider to administer the program. The Province must provide the funding mechanism for the program.

The Province will be reviewing its options including the legislative creation of a new Student Loan Administration Corporation or the establishment of a new branch within the Department. At the present time it is the view of staff that a legislatively created corporation would provide the focus and discipline on the recovery of loans necessary to ensure a more effective administration of the program.

2.3.7 Work Services and Transportation (WST)

Based on information supplied by WST, deferred maintenance is a major concern. 35% of Provincial roads, not including TCH and Argentia Access, were last paved more than 20 years ago. According to WST this compares to 22% for Nova Scotia. Also according to WST there are no roads in Ontario repaved more than 15 years ago. Furthermore, rehabilitation of bridges is an issue given that 8% are over 40 years old. WST recommends a special rehabilitation budget for bridges, ferries and roads.

2.3.8 Contingent liability for Pay Equity

The Newfoundland and Labrador Court of Appeal concluded in December 2002 that the Province is not liable for the pay equity arising for the years 1988 to 1991. The basis for this decision was that the Public Sector Restraint Act of 1991 was "… reasonable and justifiable in light of the grave threat to the economic security and well being of the Province."

The Supreme Court of Canada granted leave to NAPE to appeal this decision. This matter will be heard and likely decided in 2004.

No provision has been made in the projections for any liability that may occur from this court case.

2.3.9 Environment

The Province is facing environmental issues requiring more than $237 million for compliance with legislation and for remediation spread across several departments and agencies, each of which has indicated an inability to handle these obligations within the current expenditure levels.

(Table 7)

Environmental Issues		Estimate ($millions)
Department of Municipal Affairs		
	Regional Waste Sites	200.0
Department of Environment		
	Cleanup 5 industrial sites	5.0
NL Housing Corporation		
	Cleanup 2 industrial sites	16.0
	16 underground fuel tanks	0.6
	70 underground fuel tanks	Undetermined
School Boards		
	Underground fuel tanks	13.0 – 15.0
Works, Services and Transportation		
	Public Buildings – Remediation block funding	2.5
Source: Public Accounts for year ended 31 March 2003; departmental Briefing Notes		

In addition, the Department of Environment has identified a significant number of communities, towns and cities within the Province which are operating sewage disposal systems that are not in compliance with existing Federal legislation and which require funding for studies and new technology to determine a feasible plan to bring them to compliance.

2.4 New Commitments and Remaining Current-Year Decisions

The 2003-04 fiscal projections do not include any commitments made by the Government during the recent election.

Furthermore, this summary does not include any assumptions about any decisions that may be made by the Government for the balance of this year. For example, if the Government were to be faced with unbudgeted additional expenditures to accommodate extra snow or environmental contamination there have been no funds set aside to accommodate such contingencies. Those expenditures would affect the projected cash deficit outlook and would certainly impact on the accrual deficit if countervailing savings could not be found.

The projections in this report relate to future events and are based on the Department of Finance and Treasury Board Secretariat's assumptions, which may not remain valid throughout the period of the projections. Consequently, they cannot be relied upon to the same extent as information derived from audited accounts for completed accounting periods. For these reasons, we express no opinion as to how closely the actual deficits and cash flows achieved will correspond to the projections.

Given this situation it is not possible to predict precisely at this time what the actual deficit at the end of the year will be for the fiscal year 2003-04, which ends on March 31, 2004. The Special Review has therefore relied on the projections provided by the Department of Finance and Treasury Board Secretariat.

2.5 Management of 2003-04 Revenues and Expenditures

2.5.1 Revenues

The following table illustrates the components of fiscal provincial – federal revenues on a cash basis including budgeted and revised projections for 2003/04.

(Table 8)

($ millions)			
Revenue Source	2003/04 Budget	2003/04 Revised	Increase
Fiscal Revenues:			
Provincial Taxes	2,259.9	2,284.1	24.2
Federal	1,428.3	1,444.1	15.8
Total Revenues	3,688.2	3,728.2	40.0
Source: Department of Finance			

The Special Review has been informed that the Province intends to pursue the Federal Government on such critical issues as Offshore Revenues, Health care, equalization and CSHT.

2.5.2 Expenditures (Net of Related Revenue) – cash basis

Expenditures (net of related revenues) are expected to grow by $83.5 million during 2003-04 as forecast by Treasury Board Secretariat. These expenditure increases will be offset by expenditure savings of $43.5 million (net of related revenues) and fiscal revenue improvements of $40 million. The following table provides a summary of the major changes in expenditure:

(Table 9)

Summary of Favorable Changes to expenditure Projections (net of related revenues)	
	$ millions
Debt Servicing – Lower interest rates and strength of Cdn dollar	7.5
Disaster Assistance Revenue – anticipated receipt of federal revenues	1.0
Federal Revenue (Rooms/Heritage)	1.9
Pension contributions	2.8
Miscellaneous variance through out all Departments	30.3
Total Positive Variances	**43.5**
Source: Treasury Board Secretariat	

Table 10 provides a summary of the unfavorable expenditure variances to date and the explanation for them.

(Table 10)

Summary of Unfavorable Changes to expenditure Projections (net of related revenues)	
	$ millions
Country Ribbon Financial Assistance	4.5
Badger and west-coast floods	7.7
Court House - Goose Bay	1.0
Fisheries Processing Policy Review	0.5
Road Ambulance Service	4.0
Physician Services	20.0
Social Assistance Caseload	6.0
Provincial Roads Program	2.3
Hull 100	1.4
Relocation of Petites	1.2
Electoral Boundaries Commission	0.5
Provincial Court Judges Salary Award	1.8
Forest Fire Suppression	1.8
Student aid	1.5
WST Salary, Operating etc.	5.0
Busing & School Board Operations	3.0
Justice Salary	1.4
Employment Program	3.0
Other Anticipated Negative Variances	16.9
Net Negative Spending Variance	**83.5**
Source: Treasury Board Secretariat	

Expenditure Review ("ER")

Ultimately in order for the Government to develop a detailed plan to meet the challenge of the fiscal situation it faces, it will, as others have done in all jurisdictions across Canada, have to undertake some form of Expenditure Review to examine all programs funded by the Province to determine if there are:

- Unmet needs in priority program areas such as hospitals, schools or long term care,

- Risks being incurred due to lack of resources and or capacity to address concerns,
- Savings opportunities through organizational change or streamlining,
- Reallocation opportunities from lower priority programs to higher priority programs,
- Reduction in program budgets to reflect obsolete or lower priority programs,
- Efficiency savings due to introduction of technology or alternative methods of program delivery,
- Possible redesigns of programs to better meet the needs of the Province's population,
- Amendments to policies or legislation to better reflect current circumstances,
- Realignments of roles and responsibilities to eliminate overlap and duplication of functions between departments, agencies and, where necessary between levels of government or their agencies,
- Reviews of the potential for fines and licenses to generate increased revenues.
- Reviews of fees and other charges to ensure full cost recovery is achieved.

2.6 Risks

There are several risks to the current projections for revenues and expenditures. Some risks have the potential to have a positive impact on the deficit and some have the potential to negatively impact the deficit. From a budget management and risk management point of view clearly those risks that have the potential to negatively impact the deficit require greater focus of the Province's attention. The Province has a reputation for prudent fiscal management and failure to achieve its stated target carries both the intangible risk of reputation damage and the potential for a tangible impact in the form of a lower credit rating which could bring with it higher future public debt interest costs.

The risks, both positive and negative, identified by the Department of Finance and Treasury Board include:

- Increases or decreases in federal revenue. (note that recent federal government commitments on CHST supplements will impact 04-05 revenues and have been incorporated in the future year projections).
- Increases or decreases to oil prices and production levels would affect the revenue forecast.

- Increases or decreases to foreign exchange rates would affect the revenue forecast.
- Lower revenue risk arising from the lower than forecast economic performance, or alternatively higher revenues due to higher economic performance.
- Lower revenue risk arising out of reduced economic activity as a result of a higher Canadian dollar or vice versa
- Revenue risk as a result of the Federal Government's re-estimate of equalization, CHST, sales tax and income tax for 1999 to 2003 and first estimate for 2004 which will be completed before the fiscal year ended March 31, 2004.
- Higher or lower losses on student loan portfolio as loans are transferred.
- Risk on collections of balances owing to the Province.
- Estimation risk on the provision for retirement benefit cost (The final actuarial valuation is not due until some time early in fiscal 2004).
- Environmental incident risks that may result in high cost remediation processes having to be undertaken in the winter months.
- Expenditures to respond to public safety and work place emergencies.

2.7 Contingencies and Reserves

The Province has no further reserve or contingency left in which to absorb any unforeseen developments on either the expenditure or revenue side of the fiscal equation. This means that should additional expenditures be incurred for extra snow removal this winter or should flooding occur the "cash deficit" may not be met unless expenditures can be curtailed elsewhere.

These examples serve to illustrate the difficulty of setting a "cash deficit" target and the pressures that inevitably occur to meet the original target number.

Government may wish to consider adopting budgeting and planning practices that other Canadian governmental jurisdictions have been using, that of including explicit provisions for contingencies to accommodate unforeseen events and/or of including explicit reserves to permit the government to achieve overall fiscal targets with the "dropped allowances" going to pay down public debt in the case of surplus budgets or to reduce the planned deficit in the case of projected deficits.

If one ignores the increases in the cash deficit that are described earlier, then in all other respects the Special Review finds that the original budgeted cash deficit of $286.6 million can be achieved though this will require certain “management” of the cash flows of expenditure programs to achieve the desired result.

2.8 Reporting Entity

The Province has included on a consolidated basis 65 entities in its results. Attached is Appendix 2, a listing of the consolidated entities.

The Newfoundland and Labrador Hydro and Newfoundland Liquor Commission are business enterprises. They are accounted for on the equity basis. The Special Review held meetings with senior staff of those agencies to understand the relevance of their operations to those of the Province’s Budget position. The Special Review relied on assurances from the Department of Finance and Treasury Board Secretariat that there are no issues of financial viability concern with those agencies. Thus, and in view of the limited time available for this assignment, the Special Review did not undertake any assessments, evaluations or reviews of the financial viability of those agencies or contemplate any review in this regard.

Note that the Special Review did not include the results of the Workplace Health, Safety and Compensation Commission and Memorial University in its review since these organizations are not included in the consolidated financial statements in the Province. The Auditor General has recommended that the financial results of these two entities be included in the consolidated financial reporting of the Province. The Treasury Board Secretariat advises that as a result of revised PSAB standards, jurisdictions across Canada are reviewing the inclusion of these types of entities in their consolidated reports.

2.9 Monitoring and Reporting on Budget Performance

The Government has a system to track individual departments and agencies on a monthly basis. This facilitates government wide reporting of actual results of operations on a cash basis. The Government should modify this process to accommodate monthly accrual accounting along with fiscal year accrual projections.

2.10 Unaudited Actual Interim Financial Results

The Special Review also examined the quarterly financial statements for the Province for the first two quarters of the 2003-04 fiscal year produced by the Office of the Comptroller General of the Province.

Quarterly public reporting of results is consistent with expectations today of both public organizations including governments and private industry corporations and businesses.

To support transparency of reporting the Government should release its quarterly unaudited actual financial results on an accrual basis along with projections to fiscal year end.

2.11 Provincial Debt as at September 30, 2003

(Table 11)

Provincial Debt	**($ millions)**	
	Sept. 30, 2003	March 31, 2003
Borrowings net of sinking fund	6,600	6,460
Unfunded Pension	3,600	3,560
Other payables and accruals not including retirement benefits	1,300	1,190
Total liabilities	**11,500**	**11,210**
Source, Treasury Board Secretariat, Consolidated Financial Statements Sept. 30, 2003 and March 31, 2003		

3.0 Government Projections for fiscal 2004/05 to 2007/08

3.1 2004/05 through to 2007-08

In summary, the Special Review has found that the current and capital account cash budget <u>cannot</u> be balanced by 2007-08 with revenue growth (alone).

The Special Review examined projections of expenditure and revenue prepared by the Department of Finance and Treasury Board Secretariat that reflect the continued strong economic growth of the Province of Newfoundland and Labrador. These projections show that even with an assumed level of restraint on expenditure growth and growth in oil related revenues from a forecast $160.1 million for 2003-04 to $491.9 million in 2007-08, it will not be possible to eliminate the Province's cash or consolidated accrual deficits within the next four years.

3.1.1 Methodology

As part of the review process members of the Special Review team met with senior staff of each department to review the October budget monitoring reports and the briefing materials prepared for each of the new Ministers. The meetings were designed to provide a more thorough understanding of the issues and fiscal pressures and risks facing each department. Each department was asked to respond to a series of questions outlined in Appendix 5. In view of the time constraints on the Special Review Process departmental responses were mostly verbal, however often positions were supported by reference to existing documents within the departments.

The following is a table which summarizes the current year 2003/04 and the 2004/05 to 2007/08 projections:

(Table 12)

Projected Consolidated Accrual Deficit, Cash Deficit and Net Debt						
($ millions)						
	Original	**Revised**				
	2003-04	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
	(budget)	**(proforma)**	**(projection)**	**(projection)**	**(projection)**	**(projection)**
Revenue	4,347.0	4,352.4	4,207.9	4,221.6	4,392.5	4,516.4
Expenditures	5,012.9	5,179.6	5,196.8	5,334.9	5,516.0	5,672.3
Deficit, (accrual basis)	665.9	827.2	988.9	1,113.3	1,123.5	1,155.9
Net Debt		11,587.3	12,574.7	13,630.6	14,695.4	15,796.3
Cash Deficit	286.6	506.6	601.6	672.8	665.4	710.8
Source: Department of Finance and Treasury Board Secretariat, November 2003.						

As outlined in the above Table, the accrual deficit is projected to be in the range of $1 billion commencing in fiscal 2004/05 through the projection period.

3.2 The Economy 2003/04

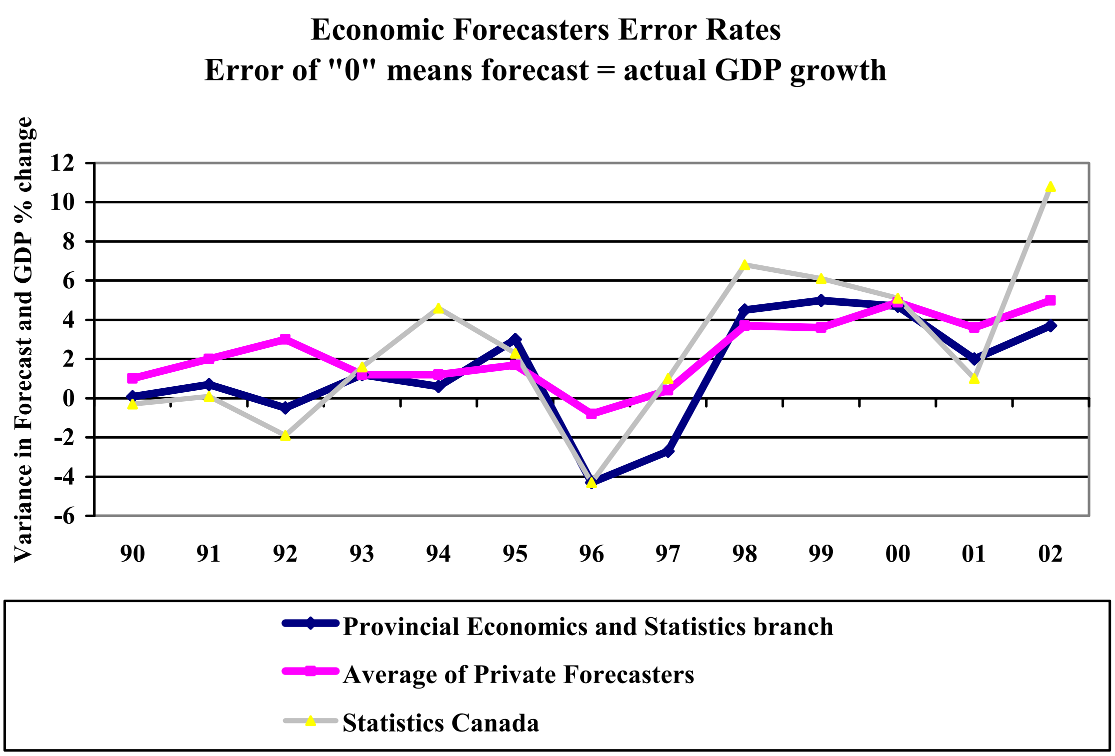
2003-04 Budget Economic Forecasts were reviewed. The most recent economic forecasts for 2003 and 2004 provided by the Department of Finance were also reviewed. Attached, as Appendix 6, is the most recent forecast.

3.3 Past Performance to Budget

3.3.1 Forecast Record

The Province has demonstrated a superior performance for its economic forecast as compared to major third party forecasters. For example, the Province's average absolute error for the 1990-2002 period is 1.8% for real GDP and 1.5% for employment.

(Table 13)



Source: Provincial Department of Finance

The Province's Economic and Statistics branch in the Department of Finance has a better record than the average of six private sector forecasters, (includes the Conference Board of Canada and five of the largest Canadian banks) as well as better than forecasts by Statistics Canada.

The data table for the above graph and data for error rates in forecasting employment growth rates are included in Appendix 4.

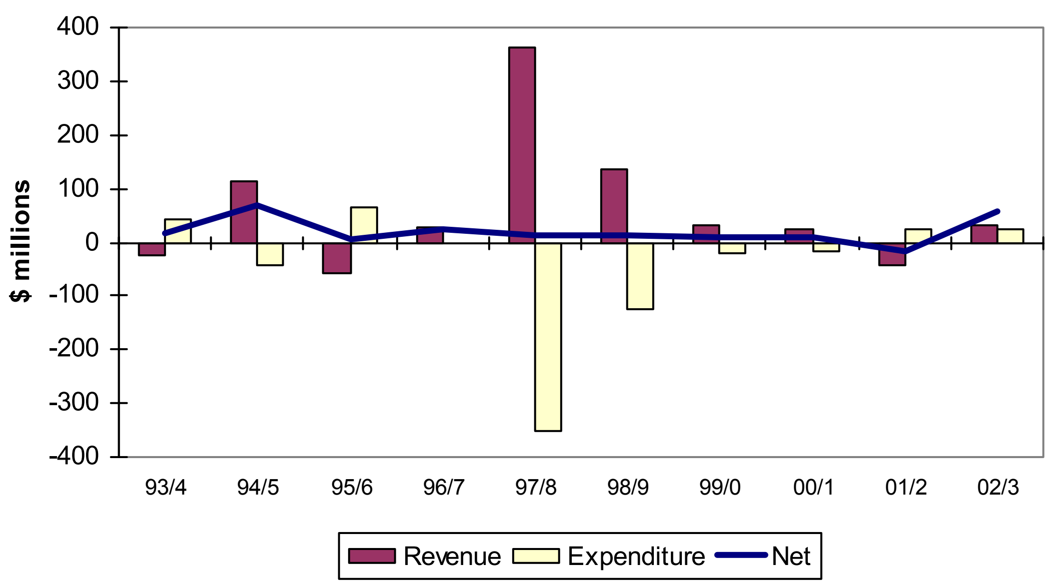
Along with the forecast accuracy the Province has shown an ability to hit the target for "cash deficits / surpluses" as was the basis of its budgeting process in prior years.

3.3.2 Budget Management Record

The Province has also achieved a strong record of meeting its cash budget surplus and deficit targets. The following table compares budget revenues and expenditures against actual results for the past ten fiscal years:

(Table 14)

Budget vs Actual (cash basis)



Summary of Budgetary Position (Cash basis)
For the ten fiscal years 1993/94 through 2002/03)
($ millions)

Fiscal Year	Budget Revenue	Actual Revenue	Variance	Budget Expenditure	Actual Expenditure	Variance
2002/03	3,959	3,989	31	4,052	4,026	26
2001/02	3,962	3,920	(42)	3,993	3,967	26
2000/01	3,704	3,730	25	3,739	3,756	(17)
1999/00	3,532	3,565	32	3,566	3,588	(22)
1998/99	3,428	3,566	137	3,438	3,562	(123)
1997/98	3,361	3,725	364	3,381	3,731	(350)
1996/97	3,393	3,420	27	3,438	3,439	(1)
1995/96	3,545	3,487	(58)	3,543	3,478	65
1994/95	3,275	3,388	113	3,471	3,515	(44)
1993/94	3,182	3,158	(23)	3,405	3,364	41
Source: Treasury Board Secretariat						

Note: these comparisons are for the "cash position" only since historical accrual data is not available. While data shows that the Province has been effective in managing to the budgeted cash deficit or surplus this does not indicate whether all programs were delivered in an efficient or effective manner as overruns in any particular area could be offset with program changes in another area.

3.4 Projections – 2004/05 to 2007/08

3.4.1 The Process used to determine future years' projections

The Special Review examined the process used to determine future years' projections.

There are two essential components of the process carried out by the Department of Finance and Treasury Board Secretariat.

The first involves a projection of future economic growth. As stated the Department of Finance Economic and Statistics Branch has an enviable record of forecasting economic growth rates in the Province.

This first component also involves translating that growth into Provincial fiscal revenue growth projections on a line by line basis. There are numerous primary sources of fiscal revenues. Once Federal Government Revenues, Personal Income Tax Revenues, HST Revenues and Corporate Income tax revenues have been accounted for the balance of the fiscal revenues represent less than 24.2% percent of total provincial revenues.

The Economic Forecast also includes the critically important demographic projections that have such a differential effect on expenditure programs in particular.

The second component involves a detailed projection by each Provincial Department of its expenditure needs and those of its agencies and other organizations funded by the Province. Large agencies such as the Newfoundland and Labrador Liquor Corporation and Newfoundland and Labrador Hydro, provide their own estimates to the departments through which they report.

Although Departments undertake long range forecasts of their expenditure programs, the Treasury Board Secretariat (TBS) adjusts those forecasts and indicates to the departments just what has been allowed. The TBS then provides an overall allowance to cover such common factors as inflation, program utilization rates and other factors that have to be applied consistently. The TBS also includes in its projections and allowances, provisions for special programs that may be growing at abnormal rates.

This approach occasionally leads to confusion. The Province may wish to review this situation to avoid any misunderstandings that may arise as to who has provided for what and why in the fiscal planning process.

3.4.2 The validity of the assumptions used in developing the projections

The table below shows the provision for an average annual increase of 3.0% on gross expenditure. Note this does not include expenses related to accrual items such as the unfunded pension and interest on that liability. In examining the 2004-2008 projections in comparison to previous records of change in government expenditure it appears the forecast expense levels should be attained if there are no significant new programs introduced without offsetting saving from existing service delivery. The Special Review finds that the projections are based on valid assumptions with the notable exception that forecast deficits in the area of $1 billion per year may not be acceptable to any of the stakeholders.

(Table 15)

Consolidated Revenue Fund Gross Expenditure Record			
	Gross Expenditure (millions)	% change	Average annual % change
Fiscal 1992 - 93	3,455		
Fiscal 1997 - 98	3,383		
Increase (Decrease) since 1992-93	(72)	-2.1%	-0.4%
Fiscal 2002-03	4,038		
Increase (Decrease) since 1997-98	655	19.4%	3.9%
Fiscal 2003-04 revised	4,266		
Increase since 2002-03	229	5.7%	5.7%
Forecast for Fiscal 2007-08	4,769		
Increase from 2003-04	503	11.8%	3.0%
Note: Gross Expenditure is consolidated revenue fund cash expenditure only.			
Does not include accrual expense for unfunded pensions and other accruals			
Source: Gross Expenditure from Treasury Board Secretariat			

Eighty percent of the expenditure base is taken up by the budgets for Health, Education and Public Debt. Health program growth is a common concern for all Ministers of Finance and Ministers of Health in Canada at both the Federal and Provincial levels.

Public Debt Interest is an expense that has seen concerns somewhat muted in the face of a series of balanced budgets and surpluses in other jurisdictions while borrowers experience the lowest interest rates in decades. However deficits and rising interest rates can awaken the public debt interest cost dragon on a moments notice. It sleeps very lightly and when awakened it can come back to give new meaning to the interest “bite” in a hurry.

In short Governments are wise to reveal the assumptions used in planning future scenarios so that there may be better information for all to understand the context in which future decisions have to be made. After all this, the financial health of the Province is not “the government’s problem” it should be the concern of every one of its 519,000 residents.

3.4.3 The reasonableness of the projected revenue and expenditures

Once the assumptions about economic and program growth rates are established they must then be comprehensively factored into projected revenues and expenditures.

In other jurisdictions internal projections are prepared that represent high medium and low probability scenarios.

In general short term projections are complex undertakings and yet a government's fiscal management credibility often rests on achieving the overall bottom line results projected in the original budgets. It is for this reason in part that other jurisdictions have adopted variations on the theme of introducing conservative, prudent, cautious, careful assumptions in their planning and budgeting projections. Under promise and over deliver wins the fiscal credibility race every time.

The projections included in this report are based on no policy change and reflect no decisions on the part of the current Government that may or may not be taken.

Noted in the "Summary Findings" is the forecast growth in oil related revenues from approximately $160 million in 2003-04 to $492 million in 2007-08. During this period the Department of Finance forecasts federal transfers to fall by $228 million from $1.444 billion to $1.180 billion.

The "Royal Commission on Renewing and Strengthening Our Place in Canada", July 2003, commented extensively on oil revenues and the reduction in equalization. Based on exchange rates, oil price forecasts and production forecasts at the time, the Commission noted the total federal and provincial royalty and corporate tax revenue from the three known oil developments; Hibernia, Terra Nova and White Rose, is projected to reach $1.15 billion in 2010 before starting to decline. The Commission concluded "Under the existing structure, after the impact of equalization, it is projected that the province would realize net revenue gains of only $250 million in that year. This means that the Government of Canada, after taking into account its equalization savings, would be the net beneficiary of the remaining $900 million."

The peak net revenue of $250 million is less than $100 million more than the revenue included in the 2003-04 budget. **Clearly this is not enough growth to offset the forecast deficits.**

With any forecast there is always a question as to what would happen if the actual experience varies from the forecast assumptions. The Special Review requested the Department of Finance and Treasury Board Secretariat to provide a table of anticipated changes to the Province's revenue and expense forecast should one of several of the key economic indicators vary. For the forecast impact of more than one change at a time, it would be required to develop a scenario of likely events and run each set through the economic model.

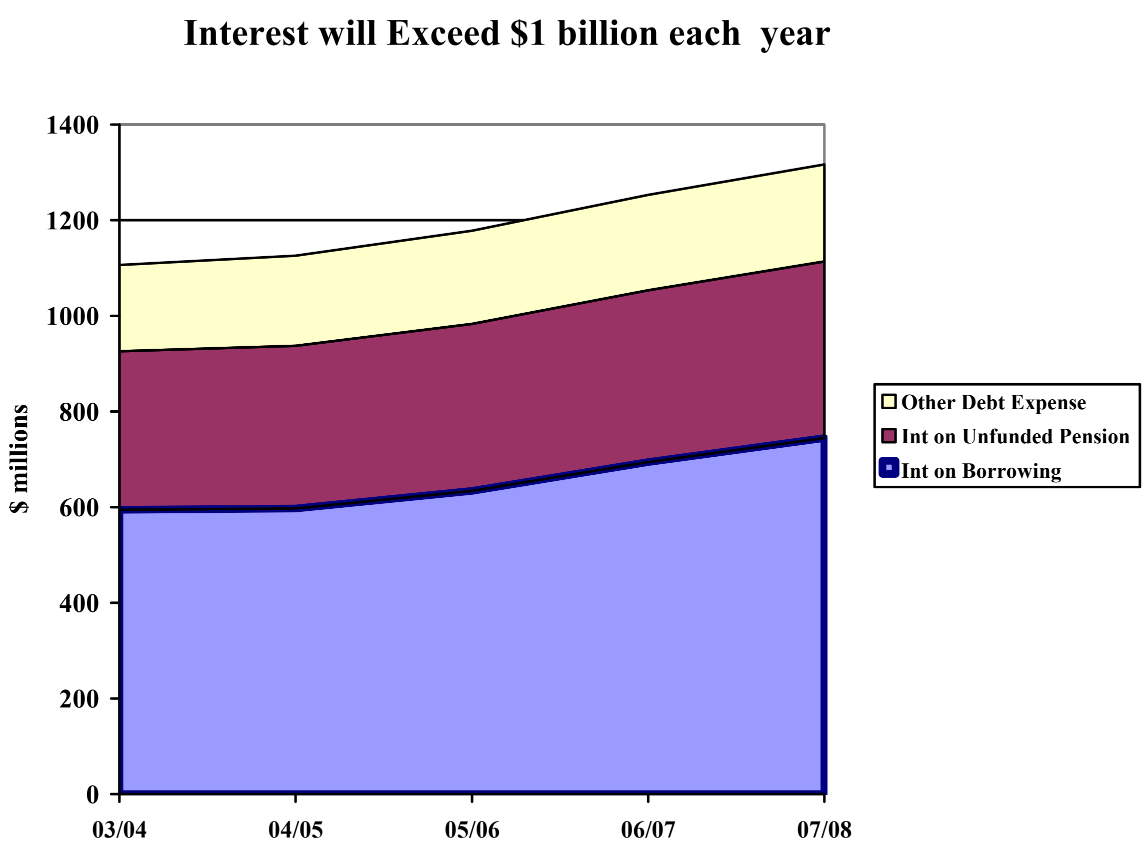
The impact on revenue of a 1% change in GDP is dependent on assumptions made regarding the sectors of the economy which are impacted. For instance, the GDP impact of changes to consumer spending would have a different impact than a change as a result of commodity exports.

(Table 16)

Estimated Annual Impact on Revenues and Expenditures		
$ millions		
A 1% increase in	**Effect**	
	Revenue	**Expense**
GDP *	11.0	
Interest Rates	-	6.0
Provincial Public Sector Wage	3.5	22.0
Provincial Public Sector Spending	5.0	36.6
Federal Transfers to Province		
Equalization	8.0	
Atlantic Accord	-8.0	
CHST	3.5	
* The revenue impacts would be lower in years where the Atlantic Accord protection was not applicable.		
1% change = 100 basis points		
Source: Department of Finance and Treasury Board Secretariat, November, 2003		

3.5 Projected Debt and Public Debt Interest

(Table 17)



	Forecast for Fiscal Year ($ millions)				
Interest Components	2003-04	2004-05	2005-06	2006-07	2007-08
Interest on Borrowings	**594.7**	**597.5**	**634.3**	**694.6**	**744.7**
Interest on Unfunded Pension Liability	**330.8**	**339.6**	**349.0**	**359.0**	**369.0**
Other Debt expenses	**181.0**	**189.7**	**196.7**	**202.6**	**206.7**
Total Public Debt Interest Expenditure	**1,106.5**	**1,126.8**	**1,180.0**	**1,256.2**	**1,320.4**
Source: Department of Finance and Treasury Board Secretariat					

The following table illustrates the Net Debt position along with the Accumulated Deficit resulting from the deduction of Non Financial Assets from Net Debt. Non Financial Assets consist primarily of Tangible Capital Assets such as buildings, roads and equipment.

(Table 18)

	Revised 2003-04	**Projected 2004-05**	**Projected 2005-06**	**Projected 2006-07**	**Projected 2007-08**
Net Debt	11,587.3	12,574.7	13,630.6	14,695.4	15,796.3
Non Financial Assets	2,260.9	2,259.4	2,202.0	2,143.4	2,088.4
Accumulated Accrued Deficit	9,326.4	10,315.3	11,428.6	12,552.0	13,707.9

The Province has generated debt of more than 4 times the long term asset values. By 2007-08, with the current trend, the debt will be more than 6 times the asset value.

The mounting debt is directly attributable to annual deficits through the projection period.

3.6 Demographic Data

The following is a summary of the key projected demographic data of the Province:

(Table 19)

Key Demographic Forecast											
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Population Growth Forecast											
Population (000's)	**539.9**	**533.4**	**528.0**	**522.0**	**519.3**	**519.6**	**518.7**	**516.5**	**515.3**	**514.4**	**513.4**
% Change	**-2.0**	**-1.2**	**-1.0**	**-1.1**	**-0.5**	**0.1**	**-0.2**	**-0.4**	**-0.2**	**-0.2**	**-0.2**
Employment Growth Forecast											
Employment (000's)	**194.2**	**204.9**	**204.6**	**211.3**	**213.9**	**218.5**	**222.1**	**223.5**	**227.9**	**229.5**	**231.0**
% Change	**2.6**	**5.5**	**-0.1**	**3.3**	**1.2**	**2.2**	**1.6**	**0.6**	**2.0**	**0.7**	**0.7**
Source: Department of Finance, Key Indicators 2003 - 2008											

4.0 Financial Condition Review

The Special Review has adopted the financial indicators from the Government's *Understanding the Financial Health of the Province*.

The Special Review also considered an updated and projected set of indicators of financial health some of which were included in the 2003/04 Budget and the balance of which were included in the Auditor General's report. The analysis of these current and projected indicators of financial health shows the extent of the challenge facing the Government and the Province of Newfoundland and Labrador. In particular these indicators project a direction of deterioration in the financial health of the Province that should be of concern to all

Those key indicators have been updated to include the fiscal projections as provided by the Department of Finance and Treasury Board Secretariat.

The following is provided by the Department of Finance and Treasury Board Secretariat for the forecast period 2003-04 to 2007-08 with March 31, 2003 data obtained from the Province's publication "Highlights and Analysis, Consolidated Summary Financial Statements, Public Accounts March 31, 2003".

The common key indicators included in this document were identified in a research report issued by the Canadian Institute of Chartered Accountants entitled *Indicators of Government Financial Condition.* These indicators which are used in assessing a government's financial health in the context of the overall economic and financial environment can be summarized under the headings *sustainability, flexibility, and vulnerability.*

The figures contained herein represent the *projected consolidated accrual* figures for fiscal years ending 2004 to 2008.

<u>Definition of Terms used in the following graphs:</u>

Annual deficit: The excess of annual expenditures over annual revenues. (Reflects amortization of tangible capital assets after capitalization of additions.)

GDP: Gross domestic product (GDP), at market prices, of the Province.

GDP source: Economic & Statistics Branch (Economic Research and Analysis), Department of Finance. Updated November 6, 2003. For each fiscal year, the GDP used in all calculations was the actual GDP for the previous calendar year (i.e. fiscal year end 2004, used 2003 GDP).

Net Borrowings: The total borrowings (debentures, Treasury Bills, etc.) less sinking funds.

Net Debt: The excess of liabilities (including unfunded pension liability/post employment liability for group medical/group life) over assets (excluding tangible capital assets).

Public Debt Costs: The cost of servicing the public debt includes interest on borrowings; unfunded pension liability/retirement benefits liability for group medical/group life.

Provincial Revenues: All monies generated from Provincial sources (e.g. taxes/user fees). Also includes net income of Government Business Enterprise's (i.e. NL Hydro, NF Liquor Corporation).

Sustainability:

- Refers to the degree to which a government can meet its existing program commitments and creditor requirements without increasing its accumulated deficit.

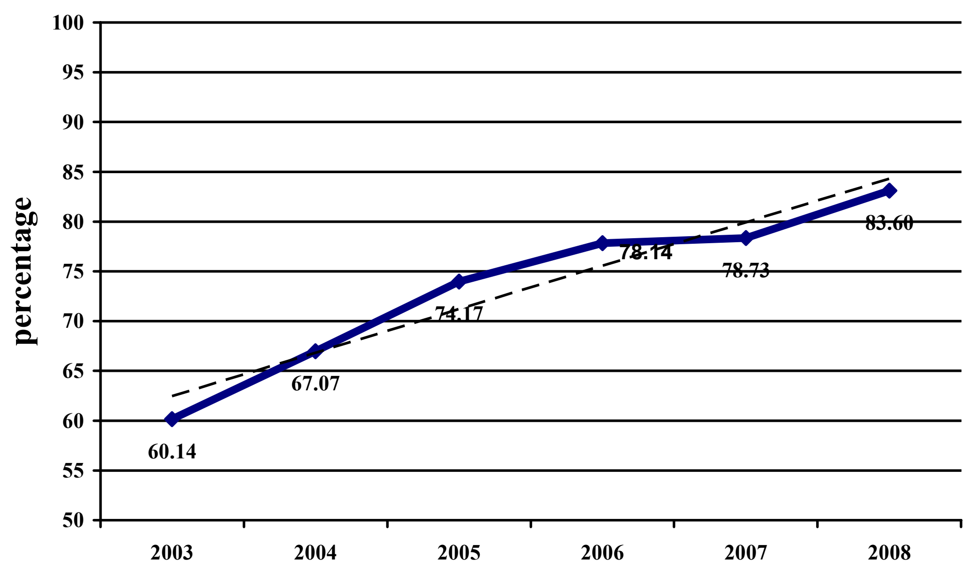
- Indicators of Sustainability:

a) *Net Debt as a % of GDP*

- Measures the level of debt that the Province carries as a percentage of its GDP.

(Table 20)

Net Debt as % of GDP

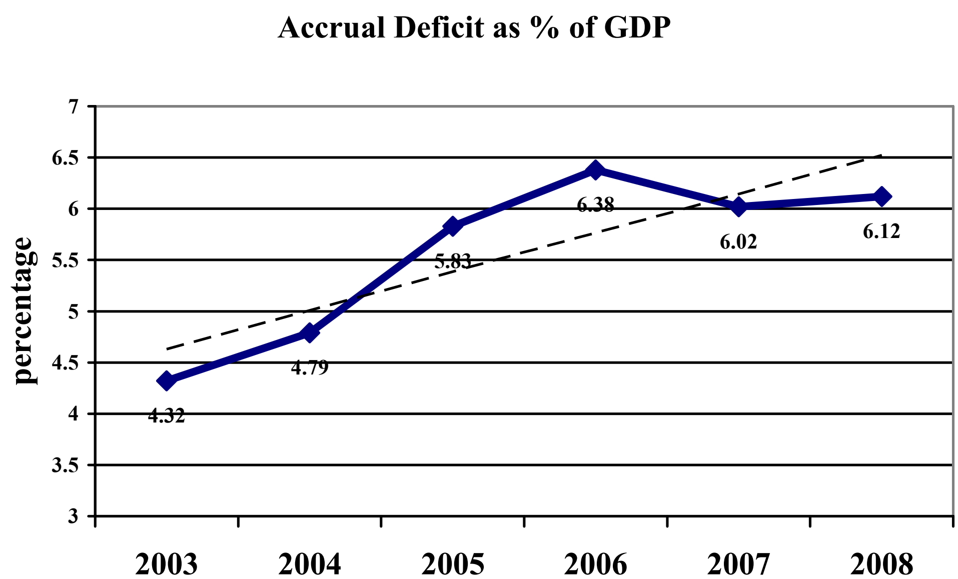


- This indicator over the five years projected from 2004 to 2008 shows an upward trend indicating the rate of economic growth will no longer be greater than the rate of the growth of the debt. Although there are no established benchmarks for what the optimal debt to GDP ratio should be, it is clear that the lower the ratio, the greater room government has to manoeuver in making fiscal decisions.

b) *Annual Deficit as a % of GDP*

• Measures the difference between revenues and expenditures expressed as a percentage of GDP.

(Table 21)



• Annual deficits as a % of GDP over the five years projected from 2004 to 2008 will increase dramatically. This is an indication that the Province may face increased difficulty to meet its financial obligations.

Flexibility:

• Refers to the degree to which a government can respond to rising commitments either by expanding its revenues or increasing its debt.

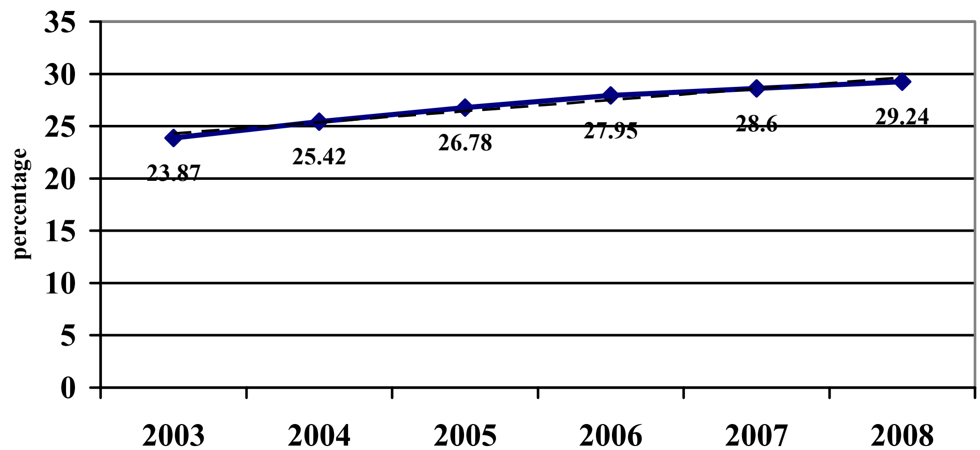
• Indicators of Flexibility:

a) *Public Debt Costs as a % of Revenues*

• Measures the extent which past borrowings may have on the Province's ability to provide for the economic and social needs of its citizens.

(Table 22)

Public Debt Costs as % of Revenues



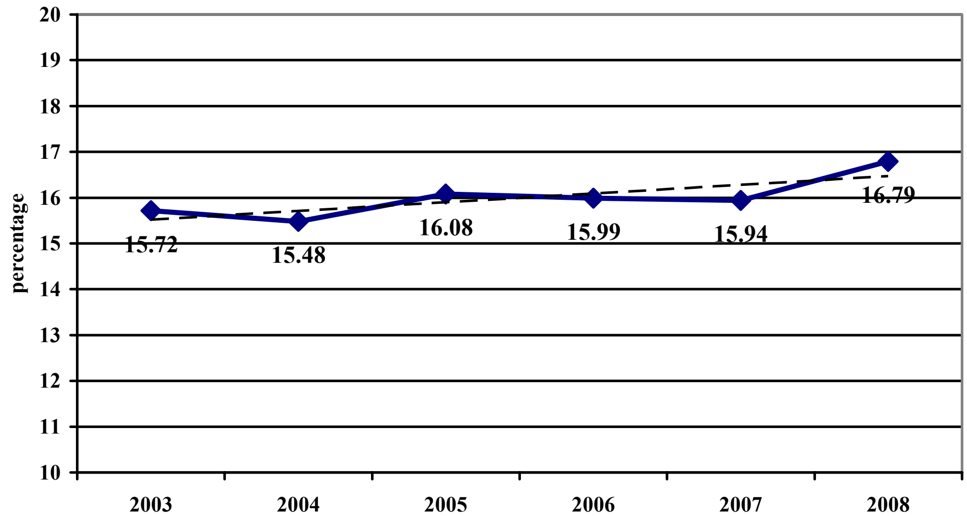
• Public debt costs continue to rise in relation to total revenues over the five years projected from 2004 to 2008 and remain a significant expense impacting funds available for program delivery.

b) *Provincial Revenues as a % of GDP*

• Measures the extent to which a government is taking income out of the economy of its own jurisdiction.

(Table 23)

Provincial Revenue as % of GDP



• This indicator shows a fairly stable picture over the five years projected from 2004 to 2008. The slight upward trend indicates that the Province would be receiving a greater benefit out of the economy.

Vulnerability:

• Refers to the degree to which a government is dependent on, and therefore vulnerable to, sources of funding outside of its control or influence.

• Indicators of Vulnerability:

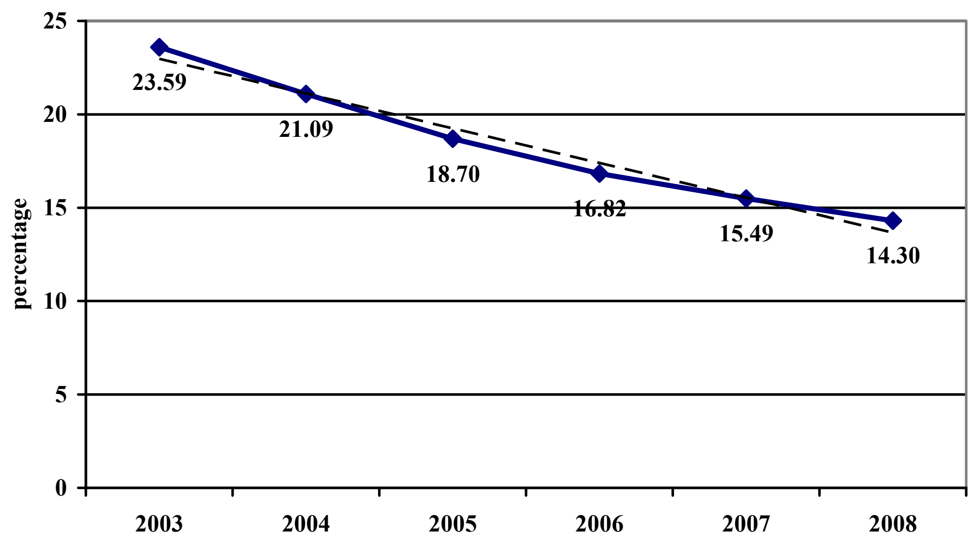
a) *Foreign Currency Debt as a % of Net Borrowings*

• Measures the amount of the Province's foreign currency debt relative to the Province's net borrowings.

• Reflects the degree of vulnerability to foreign currency swings.

(Table 24)

Foreign Currency Debt as % of Net Borrowing

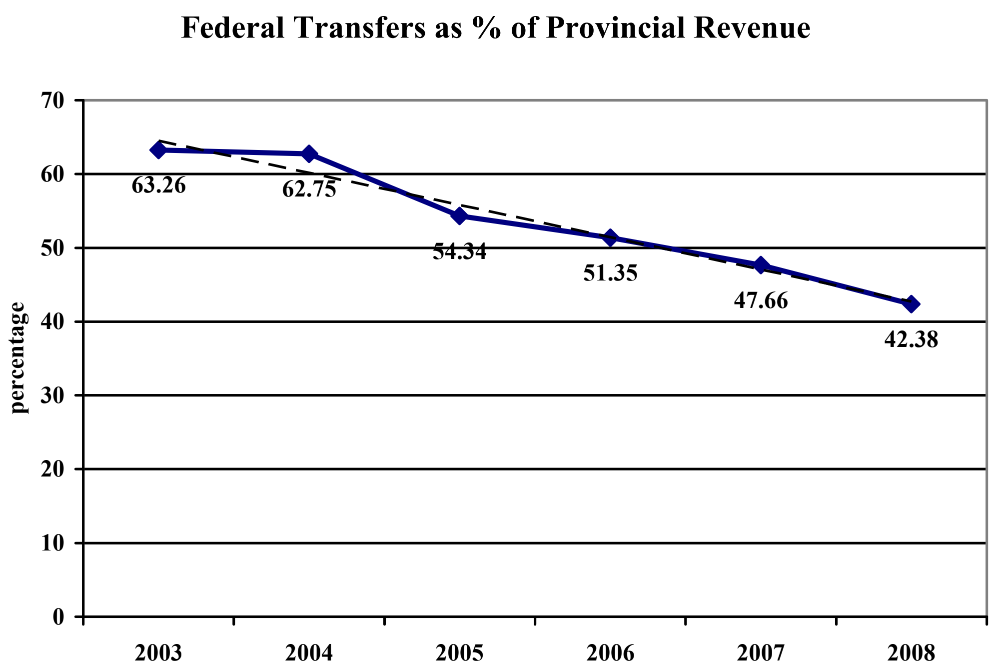


• The Province's vulnerability to foreign currency risk is projected to steadily decrease over the five years projected from 2004 to 2008. The issue for the Province is to determine what its policy target level for this indicator should be.

b) *Federal Transfers as a % of Provincial Revenues*

- Measures the extent to which the Province raises its own revenue as compared to the extent it receives funds from the federal government.

(Table 25)



- A significant portion of the Province's revenues consists of transfers from the Federal Government. Although the ratio is projected to decrease over the five years projected from 2004 to 2008, the Province is still heavily dependant on transfers from the Federal Government. Again the challenge for the Province is to determine in concert with the Federal Government and the other provinces if this an acceptable future projection, especially given the fiscal challenge that the Province is facing.

5.0 Capital Funding and Capital Deficit of Public Infrastructure

Governments in Canada have identified public sector infrastructure as a critical issue that has to be faced in the context of their overall fiscal plans on both a short and long term basis. In the face of daunting fiscal challenges short term fixes in the form of reductions in capital investments in public infrastructure will only lead to an on-going deterioration of the quality and condition of public buildings and facilities such as hospitals, schools, bridges, ferries, roads and water and sewer treatment facilities. Eventually these short term decisions have consequences that require greater expenditure of public funds to repair.

The Government of Newfoundland and Labrador faces no less daunting a challenge than ensuring that adequate funding is provided in current budgets and in planning future projections to maintain its current investment in capital stock. The Province has just made a major investment in public schools for example that will require investments in adequate annual repairs and replacements if the condition of that capital stock is to be maintained.

During the Special Review, departments were very forthcoming and compelling about the need to deal with both deferred repairs and maintenance and environmental issues and the need to provide adequate funding to meet the public infrastructure needs of Newfoundland and Labrador's growing economy.

5.1 History of Capital Expenditures

(Table 26)

Capital Budget ($ millions)	1999-00	2000-01	2001-02	2002-03	2003-04 revised
from Provincial Sources	103.2	105.9	124.7	106.6	119.2
from Other Sources	155.3	156.0	146.3	118.6	101.6
Total Gross Capital Budget	258.5	261.9	271.0	225.2	220.8
Source: Treasury Board Secretariat					

Decline in recent years is due to reduced cost shared programs.

5.2 Capital Needs

(Table 27)

Capital Budget Provided in Forecast ($ millions)	2004-05	2005-06	2006-07	2007-08
from Provincial Sources	127.7	105.0	118.3	111.0
from Other Sources	82.2	32.6	7.1	7.0
Total Gross Capital Budget	209.9	137.6	125.4	118.0
Source: Treasury Board Secretariat				

While the Provincial contribution to capital needs is maintained in the forecast relative to the recent past, the contribution from the Federal Government for known projects is shown to decrease. This could be replenished with new programs as developed by the senior government. Any new cost-shared programs will place additional pressure on the Province's finances, unless the programs are targeted directly to the Provinces pent up deferred maintenance concerns.

Noteworthy in the forecast for capital spending is that approximately 69% of the budget from 2004 to 2008 is required for projects and programs identified by Treasury Board Secretariat as already committed.

During meetings with Departmental Officials, there was a recurring theme of "deferred maintenance deficits". Departments are now reporting critical needs for repairs, alterations, equipment and investments in new construction.

Some examples of capital needs expressed by the departments:

- Health and Community Services has identified the need to address the level of investment in repairs and alterations since only $3 million is being invested each year whereas there is a backlog of needed projects and essential equipment.

- Education has identified the need for investment in deferred repairs and maintenance of schools, replacement of school buses and remediation of buried fuel tanks.

- Housing Corporation has identified deferred maintenance of much of its rental stock with concern that extended delays will result in current repairs becoming extensive refurbishments.

- Forest and Agrifoods identified water bombers are aging to the point that parts and appropriate fuel may soon become difficult to obtain.

- Several departments expressed concern that the small vehicle fleet has aged to the point that they are unreliable for the purpose intended and are impacting efficiency of service delivery.

- Works, Services and Transportation is working with a policy of trucks having a 12 year useful life and heavy equipment having a 20 year useful life, apparently much higher than industry practice. This leads to operational inefficiencies and potentially higher repair cost.

- Works, Services and Transportation provided information that the National Research Council suggests it costs 10 times more to reconstruct a road than to carry out regular maintenance, however 35% of the Provinces paved roads are more than 20 years old and at risk of needing reconstruction versus repaving.

5.3 Schedule of Net Tangible Capital Assets

The Province has acquired a large portfolio of capital assets. Currently those assets are reported as a schedule attached to the Consolidated Summary Financial Statements. The assets are recorded at estimated cost and amortized over the estimated useful life.

(Table 28)

Tangible Capital Assets		31-Mar-03			31-Mar-02
Category	Estimated Useful Life	Estimated Original Cost	Accumulated Amortization	Net Book Value	Net Book Value
	(years)	($ mil)	($ mil)	($ mil)	($ mil)
Buildings	40	1,927.6	574.6	1,353.0	1,307.3
Marine vessels and aircraft	20	82.3	54.7	27.6	27.0
Equipment and machinery	4 - 20	646.1	385.9	260.2	250.9
Infrastructure (note 1)	20 - 40	3,718.1	3,054.8	663.3	644.3
Computer software	7	27.9	19.7	8.2	10.8
Sub total		**6,402.0**	**4,089.7**	**2,312.3**	**2,240.3**
Work in progress				150.3	
Total				**2,462.6**	
Note 1: Infrastructure:	Roads		Marine facility infrastructure		
	Land		Airstrips		
	Bridges		Other infrastructure assets		
Source: Treasury Board Secretariat					

Noteworthy from the above is that even with an estimated useful life of 20 - 40 years, the infrastructure investment by the Province with an estimated original cost of $3,718 million and net book value of $663 million is amortized approximately 78%, indicating aging infrastructure that demands increasing maintenance and repair, supporting the concerns raised in meetings with the department managers.

6.0 Debt Management and Debt Ratings

(Table 29)

Debt Component Forecast Growth	\$ Millions 2003-04	\$ Millions 2004-05	\$ Millions 2005-06	\$ Millions 2006-07	\$ Millions 2007-08
Borrowings (Net of Sinking Funds)	7,241.5	8,056.7	8,959.0	9,722.5	10,533.6
Unfunded Pension Liability	3,735.7	3,914.3	4,101.7	4,299.1	4,506.5
Other Debt (includes post retirement group health and life insurance liability)	2,350.5	2,384.1	2,390.3	2,534.2	2.656.6
	13,327.7	14,355.1	15,451.0	16,555.8	17,696.7
Source: Treasury Board Secretariat					

As at September 30, 2003, the total Provincial Debt, not including the post retirement benefits liability stood at \$11.5 billion with Borrowings, net of sinking funds of \$6.6 billion. With no change in the programs and delivery methods, Borrowings net of sinking funds alone are forecast to rise to \$10.5 billion by 2008, plus the unfunded pension and other debt obligations.

6.1 Debt Ratings

The Province receives periodic credit rating assessments from the three principal rating agencies, namely, Moody's Investors Services, Standard & Poor's, and Dominion Bond Rating Service. Over the past several years the bond rating agencies have upgraded the Province's credit rating. Based on the most recent reports available, Dominion Bond Rating Service provides a BBB rating, Moody's Investors Service provides an A3 rating, and Standard & Poor's provides an A- rating. The Province's rating history is contained in Appendix 3.

Although the credit ratings are the most formal and visible form of credit worthiness, there are a host of others who comment on the budgets, fiscal plans and economic performance and outlook for the Province. Researchers for a variety of think tanks and chief economists of chartered banks as well as the Conference Board of Canada all include in their assessments, comments that represent, along with the comments of the rating agencies, a set of expectations that should be considered as part of the context for future planning.

Considerations include:

- The Province's strong economic growth performance in the past seven years. The robust outlook for the Province's economy in light of the developments in the resource sector including gas, oil and mining.
- The broadening of the Province's economic base.
- The decreased reliance on federal transfers.
- The Province's conservative debt management policies.
- The Province's declining debt burden as a percentage of GDP
- The Province's prudent budgetary and fiscal management record as well as the policies that support that record.
- Although the Province has not adopted Balanced Budget Legislation many of its management practices, targets and objectives are consistent with that approach.
- Pension liability management. The Province's efforts to negotiate benefit and contribution changes with its employees and the Province's introduction of special funding payments to assist in setting its public sector pension plans on a sound funding basis has reinforced its reputation for sound fiscal management.
- The Province's leadership efforts to move to accrual based accounting for its budgetary and financial reporting has been recognized by many observers.
- The Province's declining tax burden.
- The Province's energy industry and its growth.

There are, however, concerns that need to be addressed as the Province moves forward with its budgetary and fiscal planning that reveal consistent observations among the rating agencies and commentators in their analysis.

Areas of concern include:

- Deterioration of the Province's budgetary performance during an election year, with a common expectation that 2003-04 will be merely an aberration on the path to fiscal rectitude.
- Total debt level of the Province.
- Tax supported debt continues to be high in this Province compared to others.
- Federal revenues, particularly equalization and CHST revenues, and the lack of predictability and sufficiency continue to be cause for concern.
- Pension liabilities and the need to continue to make progress on putting the four major plans on a sound funding basis in cooperation with employee groups.
- The Province's population declines in recent years.

It should be noted that there is a heightened sensitivity to disclosure in private industry as well as in the public sector. The Province's record of taking leadership in the move to accrual reporting of its finances and other initiatives means that it has set expectations for transparent and accurate reporting of its finances. Therefore, it is imperative that every effort be made to provide disclosure where such disclosure would not harm the interest of the Province, as soon and as fulsomely as possible.

The Special Review Report includes elaborations on issues that the Province will have to face and which to some observers may come as a surprise. Therefore, every effort should be made to communicate the substance of the issues along with their consequences for the future budgeting and fiscal planning of the Provinces. It is understood that this communication should include first and foremost members of the general public, Members of the House of Assembly, Provincial employees and employee groups, as well as interested professional observers such as rating agencies, economists, commentators and members of the media.

7.0 Findings

The Special Review has found:

- The 2003-04 fiscal targets i.e. the accrual deficit target of $665.9 million and the all entities cash deficit target of $286.6 million as outlined in the 2003-04 Budget have to be revised upwards to $827.2 million and $506.6 million respectively to reflect:
  - The $220 million cost of purchasing the Student Loan Portfolio – a decision taken post-budget, and
  - The $93 million estimated additional cost on an accrual basis of retirement benefits incurred for group health and life insurance

- A preliminary estimate suggests that the unrecorded liability for retirement benefits could be in excess of $1.223 billion and that an annual accrual in excess of $100 million will be required in the future.

- The 2003-04 Budget did not contemplate having to finance the purchase of the student loan portfolio valued at $220 million from the current funder.

- The Special Review has found that the current and capital account budget <u>cannot be</u> balanced by 2007-08 with revenue growth (alone).

- On the basis of these revised projections and supporting detailed information and in particular due to the acquisition of the Student Loan portfolio the Special Review finds that the 2003-04 fiscal targets outlined in the Budget no longer remain realistic and attainable.

In setting new directions in management of the Province's financial future the Government faces choices and tough choices.

Yours very truly,

PricewaterhouseCoopers LLP