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Debt Reduction Plan 2005

Debt Reduction and the
Offshore Offset Agreement

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Summary

The Government of Nova Scotia has a unique opportunity in 2005–2006 to proceed with a new debt reduction plan.

The Government of Canada has committed to provide Nova Scotia with a payment of $830 million in this fiscal year to compensate for offshore resource revenues clawed back under the equalization formula. Premier John Hamm has made the commitment to apply the full amount of this payment to Nova Scotia's debt.

With almost $12.4 billion in net direct debt forecast as of March 31, 2005, the Government of Nova Scotia recognizes that stabilizing and reducing the debt must continue to be a priority.

Placing this offshore money on the debt is one of a series of measures undertaken since 1999 to contain spending and plan for debt reduction.

Government implemented generally accepted accounting principles (GAAP) and made a number of important business decisions such as closing Sydney Steel. During the same period, government enacted balanced budget legislation and brought in four consecutive balanced budgets, including the current budget of 2005–2006.

Government also introduced a Debt Reduction Plan in 2003, with related legislation in 2004, that added specific provisions for ongoing debt reduction.

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The Debt Reduction Plan of 2005 builds on these previous measures and incorporates the new circumstances created by the Offshore Offset payment, which is expected at some point this year from the federal government. Specifically,

- The $830-million Offshore Offset cash payment will be used to retire outstanding debt in 2005–2006.

- Government will be required to produce surpluses at least equal to that portion of the $830 million recognized under GAAP as revenue earned from the Offshore Offset in each of the next eight years.

- Government will continue to be required to place extraordinary revenue on the debt.

- A Public Debt Management Fund will be maintained for the purpose of debt retirement and debt reduction.

- The Financial Measures Act will formalize the 2005 Debt Reduction Plan in legislation.

The 2005 Debt Reduction Plan is a focused way for government to meet its debt reduction targets for 2007–2008 and beyond.

In effect, the $830-million debt payment allows the government to reduce the debt faster than anticipated in previous debt reduction strategies.

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Debt Reduction and the Offshore Offset Agreement

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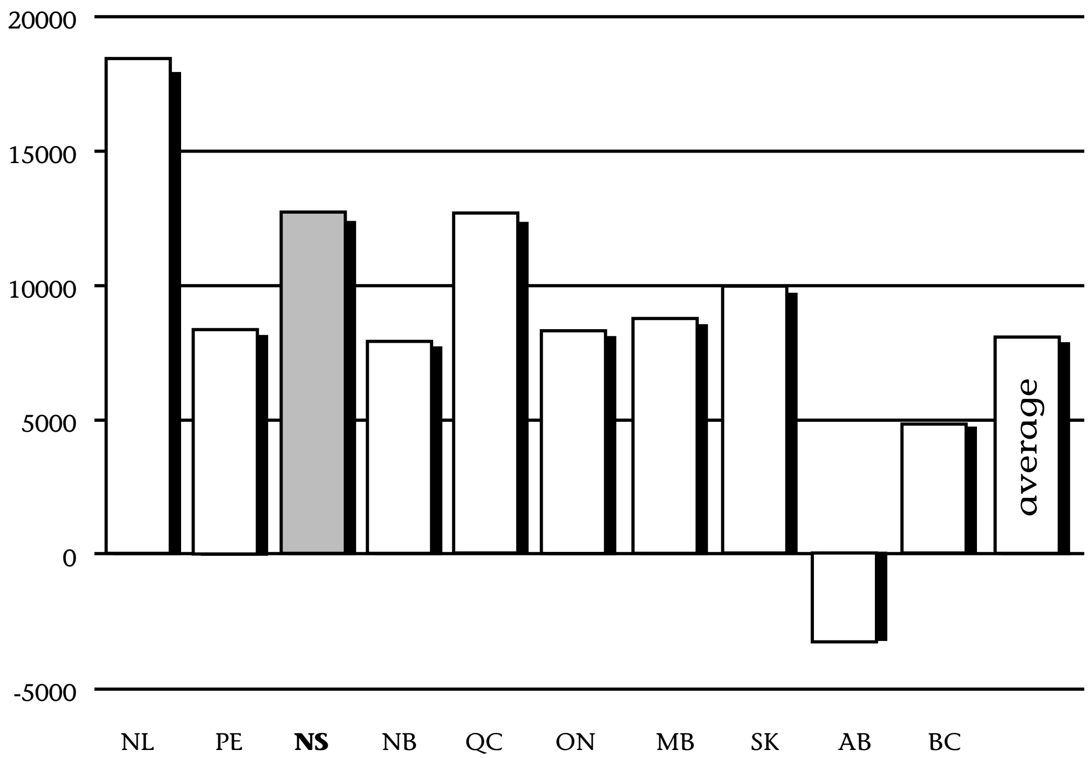
Introduction

The Province of Nova Scotia has one of the highest debt levels in Canada. With almost $12.4 billion in net direct debt forecast as of March 31, 2005, Nova Scotia has the second highest debt per capita in the country.

Provincial Debt per Capita as at March 31, 2003
(per cent)

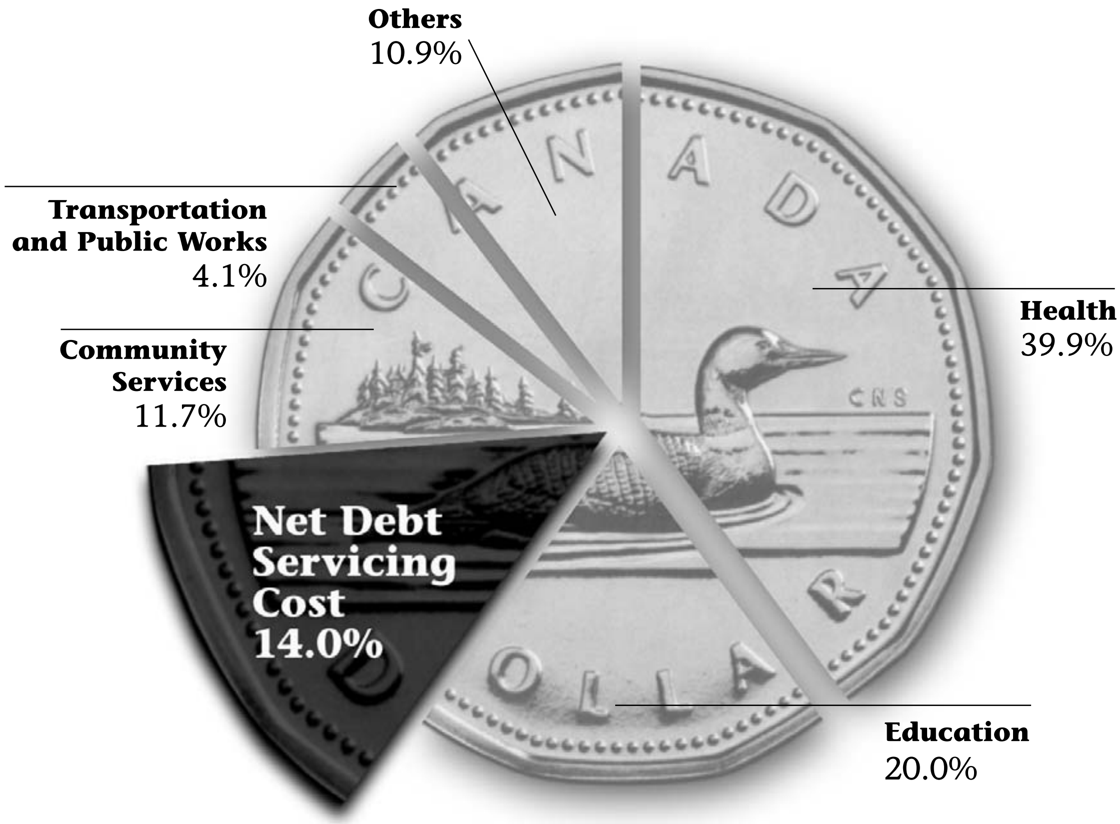


(Source:Statistics Canada, Table 3885-0014, Provincial Net Debt at March 31, 2003, population from Statistics Canada July, 2004)

High debt levels keep Nova Scotia from being as successful as it can and should be. Fourteen cents of every dollar the province takes in each year go to pay the interest on the debt. After health care and education, debt servicing is the province's next largest expenditure.

The Government of Nova Scotia started a process in 1999 to stabilize the debt and see it drop over time. A number of positive measures have been undertaken in the last five years, including the Debt Reduction Plan of 2003.

Departmental Expenses as a Per Cent of Total Spending
(Estimates for 2005–2006)



(Source: Calculated from the 2005-2006 Nova Scotia Budget)

With the payment of $830 million from the Offshore Offset Agreement, Nova Scotia is now in a position to update its debt reduction strategies. The Debt Reduction Plan of 2005 continues government's commitment to make debt reduction a priority.

History of Nova Scotia's Debt

Nova Scotia's debt accumulated through the 1980s and 1990s. Successive governments ran large operating deficits, took on new capital spending obligations, and supported major initiatives such as Sydney Steel Corporation (Sysco) and Nova Scotia Resources Limited (NSRL).

Under the accounting system used at the time, liabilities related to entities such as NSRL and Sysco were not included in the province's budget.

In 1999, the Government of Nova Scotia started to define its assets and liabilities more comprehensively. Generally accepted accounting principles (GAAP) were phased in, and between 1999 and 2004, some previously incurred liabilities were recognized on the province's books for the first time. These included costs such as P3 school leases, obligations for future employee pensions and benefits, and the deficits and environmental liabilities of Sydney Steel.

These changes created the largest component of the $2.45-billion rise in the accounting calculation of debt—known as the net direct debt. Most of the increase came from the application of proper accounting principles, and not from operating deficits.

Change in Provincial Net Direct Debt March 31, 1999 to March 31, 2005
(numbers in $ millions)

Net Direct Debt - March 31, 2005 (f)	12,381.2
Net Direct Debt - March 31, 1999	9,928.1
Increase	2,453.1
Accounting Changes	1,141.2
Closure of Sysco and Sale of NSRL	240.6
P3 Leases	484.8
Other	586.5
Change in Net Direct Debt	2,453.1

During the same period, government made efforts to stop the debt from growing due to accumulated deficits. Government passed the Financial Measures Act in 2000, requiring budgets to be balanced by 2002–2003.

A more disciplined fiscal management system was adopted, and government introduced its first balanced budget in 2002–2003. There have since been four consecutive budget surpluses.

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In 2003 and 2004 the province's credit rating was upgraded by all three major bond-rating agencies. Moody's Investors Services cited long-term improvements in debt indicators, economic gains of recent years, and the government's commitment to balanced budgets and achieving a reduction in debt.

How Is Nova Scotia's Debt Calculated?

Debt levels for a provincial government like Nova Scotia are commonly measured two different ways: net debt and net direct debt. With different components, these two measures of debt often differ.

Net Direct Debt (an accounting measure of debt)

Net direct debt, defined as total liabilities less financial assets, is based on full accrual accounting. Revenues and expenses are recorded when they are incurred, as opposed to when the cash is received or spent.

For example, pension obligations for employees who may retire many years from now are included in the province's annual operating expenses as they are earned, long before the pension benefits are actually paid in cash.

Similarly, amortization or depreciation on capital assets is recorded annually as an expense, to reflect the value of the asset used.

Net direct debt is affected by the deficit or surplus. It goes up if capital expenditures (the money spent on infrastructure such as roads, schools, and buildings) minus amortized costs are greater than the surplus. Net direct debt decreases if capital expenditures minus amortized costs are less than the surplus.

Net Debt (a cash-based measure of debt)

Net debt is the gross debt less sinking fund assets held by the province. To bondholders, it represents what they are owed collectively.

Debt-servicing costs are paid on the debt owing, offset partially by interest earned on the province's financial assets held in sinking funds and other debt management funds.

Net debt includes

- bonds and debentures sold to investors that must be paid back
- money borrowed from the Canada Pension Plan and other short- and long-term loans

minus

- investments that make the government money, such as sinking funds and other financial assets.

Net direct debt, over the long term, could be equal to net debt. However, in the short term, the two amounts are likely to be quite different.

For example, in fiscal year 2002–2003, the province's net direct debt increased by $566.9 million as the result of accounting changes to recognize, among other things, post-employment benefits of employees. These changes had no cash impact, as the province did not borrow money for them.

Nova Scotia's net direct debt is currently higher than the net debt. Forecasts, as of March 31, 2005, show the net direct debt to be $12.4 billion and the net debt to be $10.2 billion (gross debt $13.1 billion less investments of $2.9 billion).

The province's ratio of Net Direct Debt to gross domestic product at market prices continues to decline. It is forecast to stand at 41 per cent at March 31, 2005, down from 42.7 per cent a year earlier.

Using Offshore Offset Revenues to Pay Down Debt

The Offshore Offset Agreement was signed by the Province of Nova Scotia and the Government of Canada on February 14, 2005. The Government of Nova Scotia expects that the appropriate federal legislation to formalize the agreement will be passed sometime in 2005–2006.

The Offshore Offset Agreement fulfills long-standing commitments by the Government of Canada in 1982 and 1986: that Nova Scotia would be the principal beneficiary of petroleum development offshore.

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The intent was to give Nova Scotia a much-needed opportunity to create a stronger economy using offshore oil and gas resources. This was similar to opportunities provided previously to other provinces.

However, Nova Scotia did not benefit as promised from its offshore resources; royalty and other offshore revenues were clawed back under the equalization program. For every dollar that Nova Scotia received in revenue from the offshore, 81 cents went to the federal government, while Nova Scotia retained 19 cents—a far cry from the promised 100 per cent.

The Offshore Offset Agreement effectively changes the treatment of offshore royalties, by compensating for revenue losses under equalization for an eight-year renewable period.

The agreement is structured so that the province receives an upfront payment of $830 million as a floor. The actual amount of the agreement will be based on natural gas prices and production. If these rise beyond levels assumed in the agreement, Nova Scotia will receive the full 100 per cent benefit of those increased offshore revenues. Preliminary projections put the value of the agreement over eight years in the range of $1.1 billion. The agreement can be extended for a further eight years under certain conditions.

The 2005 Debt Reduction Plan

Nova Scotia is taking a new approach to debt reduction in 2005–2006.

The $830-million debt payment allows the government to reduce the debt faster than was possible before.

The plan follows previous measures to contain spending and reduce debt, including balanced budget legislation passed in 2000. It replaces the Debt Reduction Plan of 2003.

The 2003 debt reduction plan, formalized by the 2004 Financial Measures Act, included provisions to

- give government authority to create a debt retirement fund
- require a minimum $6-million annual deposit into a debt retirement fund
- require any extraordinary revenue to go to a debt retirement fund

The goal of the 2003 debt reduction plan was to start reducing net direct debt in 2007–2008.

The 2005 Debt Reduction Plan builds on these previous measures and incorporates the new circumstances created by the Offshore Offset payment.

Specifically,

- The $830 million Offshore Offset cash payment will be paid into the cash debt in 2005–2006.
- The various debt retirement and management funds will be combined into a Public Debt Management Fund, which will be maintained for the purpose of managing the public debt.
- Government will be required to produce surpluses at least equal to the amount recognized under GAAP as revenue earned from the $830 million offshore payment in each of the next eight years.
- Governments will continue to be required to place extraordinary revenue into the Public Debt Management Fund.

The Financial Measures Act of 2005 formalizes the changes in the 2005 Debt Reduction Plan.

2004 FMA

- Establishes Debt Retirement Fund
- Includes annual $6-million deposit
- Requires that extraordinary revenues go to the fund

2005 FMA

- Consolidates Debt Retirement and Management Funds
- Eliminates annual $6-million deposit
- Continues placing extraordinary revenues in the fund
- Legislates that $830 million will not be used for balanced budget purposes, as required in the Provincial Finance Act

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The new scenario sees Nova Scotia's debt continue to decline beyond 2007–2008. The government has committed that after 2011–2012, the last year of the eight-year agreement, the province will post surpluses sufficient for continued debt reduction.

Notional Revenue Allocation for Debt Reduction from the Offshore Offset Agreement
(numbers rounded to nearest $ millions)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Deferred Revenue to be recognized–accrual	–	57.1	93	189	207	151	92	41
Cash Payment on Debt	–	830	_	_	_	_	_	_

The 2005 Debt Reduction Plan is a focused way for government to meet its debt reduction targets for 2007–2008 and beyond.

In effect, the $830-million debt payment allows the government to reduce the debt faster than anticipated in previous debt reduction strategies.

How Will the Debt Levels Be Affected?

Nova Scotians will see the benefits of debt reduction on both net debt and net direct debt. It is the payment on net debt that will free up the debt-servicing costs.

Net Debt

The $830 million will be paid on the net debt as soon as funds are received. The monies will be used to pay down existing long-term and short-term provincial debt outstanding in financial markets. With $1.6 billion in debenture debt maturing in 2005–2006, the Province of Nova Scotia has a number of options to repay debt.

The Department of Finance enhanced its ability to use these funds by postponing borrowing in late 2004–2005 in anticipation of the federal government providing the Offshore Offset funds. Thus, Nova Scotia will immediately see a benefit in lower debt-servicing costs.

The province will have significantly reduced borrowing requirements in future years, when annual debt-servicing costs are expected to drop by approximately $50 million. These funds can be redirected towards the priorities of Nova Scotians.

Net Direct Debt

The $830 million does not have an immediate impact on the province's net direct debt. Under GAAP, revenue will be recognized each year over the eight-year period as "earned." It will thus have an impact on our overall deficit or surplus calculation.

The Financial Measures Act of 2005 outlines the amount of revenue from the offshore funds to be used for debt reduction in each of the next eight years. That portion of the $830 million recognized in each year will be assigned to the surplus, affecting each year's net direct debt by that amount.

Net direct debt will start to decline in 2007–2008 and will continue to decline every year thereafter.

Net direct debt is projected to be approximately $150 million lower by 2007–2008 than the amount anticipated in the 2003 plan.

Also, compared to the 2003 plan, it is projected that

- Debt reduction will be higher in 2006–2007 through 2009–2010.
- The ratio of net direct debt to gross domestic product is projected to be 36.5 per cent in 2007–2008, down from the 2004–2005 forecasted level of 41.0 per cent.

Conclusion

A reduction in Nova Scotia's debt—by whatever measure is used—improves the province's financial footing.

Offshore oil and gas are a non-renewable resource. At some point in time, revenue from the offshore industry may stop. It is important that the revenue the province receives today from the offshore is invested where it will deliver the best return for Nova Scotians.

The offshore funds will immediately reduce the net debt and, over time, will help the government reduce the net direct debt.

The government has made a commitment to reduce the net direct debt of the province in 2007–2008 and in every year thereafter.

Detailed Definitions— Net Debt and Net Direct Debt

Net Debt

Net debt is equal to gross debt, or the value of borrowings, less related investments (i.e., sinking fund assets).

Gross debt consists of debentures and medium and short-term promissory notes. The value of the province's gross debt for a given year is made up of outstanding debentures plus borrowing during the year less debt retirement, changes in foreign exchange gains or losses, and changes in other unfunded debt.

This total is offset by investments in the public debt management fund and sinking funds. See Schedule 19, page D23, in the 2005–2006 Budget Address for a full breakdown of gross and net debt.

The $830-million retirement of outstanding debt in 2005–2006 will decrease the amount of gross debt and net debt.

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Net Direct Debt

Net direct debt is defined as total liabilities less financial assets.

It is an accounting term, equal to the accumulated amount of accounting deficits or surpluses for each year, plus the investment in capital assets less amortization (the difference between these two is called the change in net book value), plus or minus changes in inventories and pre-paid expenses.

In order for the net direct debt of the province to decrease, the total surplus must be greater than the change in net book value of assets.

For example, in 2007–2008 the province is projecting a surplus (for the purposes of debt reduction) equal to $189 million, which is the estimated revenue that would be recognized for accounting purposes from the Offshore Offset Agreement; capital spending less amortization equal to $93.5 million.

The impact of these numbers will result in the net direct debt of the province being reduced by $95.5 million in 2007–2008.

Net Direct Debt April 1, 2007	$12,516.9 million
Less:	
Surplus (Offshore Offset Revenue)	(189.0 million)
Plus:	
Change in Net Book Value of Capital Assets	93.5 million
Net Direct Debt March 31, 2008	$12,421.4 million

See Schedule 20, page D24 in the 2005–2006 Budget Address for the complete schedule.