FITCH AFFIRMS PROVINCE OF BRITISH COLUMBIA, CANADA'S RATING AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-28 June 2018: Fitch Ratings has affirmed the Province of British Columbia's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'AAA' and Short-Term IDR at 'F1+'. Fitch has also affirmed the province's senior unsecured long- and short-term debt at 'AAA' and 'F1+', respectively. The Rating Outlook is Stable.

British Columbia benefits from a broad and steadily growing economy, and conservative and prudent fiscal management with moderate debt levels. Provincial economic performance has been generally positive since the recession, and is likely to exceed performance of most other provinces in the near to medium term. The solid growth supports stable fiscal results and provides a strong resource base for British Columbia's long-term liabilities.

KEY RATING DRIVERS

Institutional Framework (Strength/Stable)

The 'AAA' ratings are supported by the strong institutional framework under which the province operates in Canada (IDR 'AAA'/Outlook Stable). Provinces operate with a federal structure splitting responsibilities between the provinces and the sovereign. Provincial governments retain significant independent fiscal authority, with clearly established guidelines and statutes governing transfers between levels of government. Within broad constitutional and statutory limits, the provinces are fairly autonomous governing entities with independent fiscal controls over revenues and spending.

Economy (Strength/Stable)

British Columbia's diverse economy continues its steady pace of economic growth, ahead of most other provinces and provides a robust resource base for provincial government spending plans. Labor market conditions remain solid, and the government is forecasting modest GDP growth, albeit at below pre-recession rates. Consistent with the prior government, the current government's latest three-year fiscal plan (Budget 2018) includes expense contingencies and forecast allowances around cautious economic forecasts to support continued balanced budgets.

BROAD ECONOMIC BASE CONTINUES GROWTH

GDP growth exceeds most other provinces, although it remains below its pre-recession pace and appears likely to slow in the near term in line with national expectations. The province is a key contributor to Canada's overall economic profile with provincial real GDP in 2017 accounting for approximately 13% of national GDP. Distribution across sectors is similar to the national distribution, although natural resources are critical for portions of the province's vast interior. Other sectors including finance, insurance and real estate activities and education and health services, based mainly in Metro Vancouver and other urban areas, are significantly larger components of the province's GDP.

Leading up to the global recession that began in 2008, British Columbia's real GDP growth rate outpaced national trends and the downturn was less severe in the province than for the nation as a whole. While the province's initial recessionary recovery was somewhat less robust than the nation's, recent performance has been stronger. In 2017, 3.9% real GDP growth exceeded the national gain of 3.3% and was second highest amongst all provinces.

The provincial government's forecast in February's Budget 2018 for real GDP growth in 2018 and 2019 of 2.3% and 2% growth, respectively, is ahead of its national growth forecasts of 1.8% in 2018 and 1.7% in 2019. Fitch's more recent June 2018 Global Economic Outlook projects 3% national growth in 2018 and similar slowing growth of 1.6% in 2019. As in prior years, the government's real GDP growth assumptions for British Columbia in Budget 2018 are below the outlook from the province's private sector Economic Forecast Council. Budget 2018 assumptions are lower by 0.2 percentage points (pp) in both 2018 and 2019, and by 0.1pp for 2020 through 2022. This gap provides some budgetary cushion as the economic assumptions are a key driver of the province's revenue outlook.

British Columbia's employment growth (measured by the Labour Force Survey) accelerated in 2017, increasing 3.7% versus 1.9% national growth. As with GDP, the province anticipates growth will continue through its three-year fiscal plan but at a more moderate pace. Population growth should also continue, though similarly at lower rates than recent years. British Columbia's current population of approximately 4.8 million is up 12% since 2007. Economic weakness in neighboring Alberta drove inter-provincial migration into British Columbia over the past few years but that trend has slowed as Alberta's economy has strengthened. International migration will likely support continued population gains in British Columbia.

Fitch views potential slowdowns in the U.S. and Canadian economies as key economic risks for British Columbia. Given the close linkage with the U.S. economy, unanticipated weakness there or disruptions to longstanding trade agreements could have quick and significant implications for the province's economy. Despite a more diversified export base than other provinces, notably in Asia, the U.S. remains the destination for the majority of British Columbia's exports. A steep housing price correction, which Fitch considers the Vancouver market increasingly vulnerable to, also poses some risk. While Budget 2018's economic and fiscal assumptions include some moderation in housing market activity, a sharper decline could affect broader economic activity in the province.

Debt (Strength/Stable)
The province's debt burden remains in line with the current rating level with operating debt projected to be fully retired by fiscal 2019 (the current fiscal year, which began on April 1). The government projects taxpayer-supported debt-to-GDP will increase modestly through the updated three-year fiscal plan. Risks around the expected growth of self-supporting debt could pose potential rating pressure, in the event that capital projects require general government support.

WELL-MANAGED DEBT PROFILE

Fitch believes British Columbia's debt position is well-managed and compares favorably to that of its provincial peers. The province also benefits from ample access to well-regulated, liquid domestic and international capital markets.

Taxpayer-supported debt stood at 15.7% of GDP and 81.8% of revenue at the end of fiscal 2017. Total provincial debt ratios were higher at 25% of GDP and 99.3% of revenue, including self-supporting debt of the Province's commercial Crown business enterprises with their own-source revenues, including utility revenues of the provincial-owned BC Hydro, to fund debt obligations. Borrowing and debt levels increased during the recession and initial recovery for deficit financing and economic stimulus purposes, consistent with how Canadian provinces manage economic and revenue cyclicality.

Positively, the province resumed reducing outstanding direct operating debt in fiscal 2015 following three years of increases, and in Budget 2018 the government anticipates eliminating it entirely this fiscal year. Taxpayer-supported debt levels as a percent of GDP also declined in fiscal 2015 through fiscal 2017. British Columbia projects the ratio to remain relatively stable at approximately 16% through the fiscal plan, supported by solid GDP growth. The stabilization in debt ratios comes despite the government's cancellation of tolls on the Port Mann Bridge during fiscal 2018. The toll elimination led to the shift of C$3.5 billion from self-supporting to taxpayer-supported debt. Taxpayer-supported debt was C$41.5 billion in fiscal 2017, escalating to C$45.2 billion in fiscal 2019 and C$50.3 billion by fiscal 2021 under Budget 2018. Total provincial debt, including self-supporting debt, was C$65.9 billion in fiscal 2017 and also increases through the fiscal plan to C$77.1 billion by fiscal 2021.

Taxpayer-supported debt to revenues increases from 81.8% in fiscal 2017 to 84.9% in fiscal 2019 and 88.3% of revenue by 2021. Fitch considers these levels within the province's ability to prudently manage at the 'AAA' rating level.

RISKS ASSOCIATED WITH SELF-SUPPORTING DEBT

Budget 2018 projects that total provincial debt will remain relatively steady at approximately 24% of GDP, but the debt-to-revenue ratio will increase to 101.2% by 2021 from the 95.5% forecast for fiscal 2018. Fitch anticipates these ratios could increase further given demands around BC Hydro's Site C project.

Last fall, the BC Utilities Commission issued reports indicating the Site C hydroelectric dam project was behind schedule and at risk of going over its nearly C$9 billion budget. Later that year, the premier announced that BC Hydro will complete the Site C project with a new budget of C $10.7 billion (with C$2 billion spent to date) that includes a C$700 million project reserve. The project will remain a BC Hydro self-supporting project paid from utility revenues. The timing for additional debt for Site C will extend beyond the Budget 2018 fiscal plan, as the scheduled completion date is in 2024.

The government has established additional oversight for the Site C project to contain further cost overruns and the project budget includes a total of C$1.6 billion for project contingency and reserves; however, the project remains complex and several years from completion, leaving risk for BC Hydro and the province. Also, Fitch anticipates the government will pursue an alternative to the C$2.3 billion George Massey Tunnel replacement project it put on hold and removed from its capital plan last year, which could also add to provincial debt levels or require offsetting changes to other taxpayer-supported infrastructure projects.

Management (Strength/Stable)

The province's prudent managerial practices are also a key factor supporting British Columbia's 'AAA' IDR. Annually released multi-year budgets allow for long-term fiscal planning, while quarterly intra-year published updates provide management with the opportunity to address changing fiscal and economic circumstances. As noted earlier, revenue estimates typically rely on conservative economic growth forecasts. And budgeting includes prudence measures on the revenue and expenditure side to account for unanticipated spending pressures.

Fiscal Performance (Strength/Stable)

British Columbia's new government released its three-year fiscal plan in February that maintains balanced budgets with modest surpluses for fiscals 2019 to 2021. Budget 2018 relies on continued economic growth and significant revenue measures to fund spending boosts for key policy goals. The plan also relies on successful implementation of policy changes affecting the Insurance Corporation of British Columbia (ICBC) to stem operating deficits. ICBC is a provincial crown corporation that is the sole provider of basic auto insurance in British Columbia, and also offers optional auto insurance in a competitive marketplace. If the measures to address ICBC's projected operating losses fall significantly short, the province could tip into unexpected deficits.

FISCAL DISCIPLINE YIELDS MODEST SURPLUSES

Fitch considers British Columbia's financial planning and controls to be strong and institutionally embedded. These practices are key reasons for the province's track record of timely returns to fiscal balance following recessions and consistent operating surpluses during economic expansions. In Budget 2018, the province estimates its fifth and sixth consecutive balanced budgets in fiscal 2018 and 2019. For fiscal 2019, the budget projects 3.5% growth in operating expenditures to C$53.6 billion with a projected surplus of C$219 million, or 0.4% of revenues.

During the downturn, British Columbia ended fiscal 2010 with a deficit of approximately C$1.8 billion (approximately 5% of revenues) following five years of surplus operations. The province embarked on a successful multi-year fiscal consolidation plan and generated the first of four consecutive operating surpluses in fiscal 2014 with another likely surplus in fiscal 2018 which ended on March 31.

In addition to an economic forecast cushion, the fiscal plan incorporates prudence measures in each year in the form of forecast allowances and a contingencies expense line item (a combined C$900 million in fiscal 2019, or 1.7% of revenues), to guard against unforeseen weakness. By 2021, the province projects a narrow C$284 million surplus, or 0.5% of revenues. The combined prudence measures provide C$1.35 billion (2.3% of revenues) in budgetary cushion. Contingencies, forecast allowances, and conservative economic growth assumptions are all long-standing aspects of the government's budgetary and fiscal planning.

ICBC POSES OPERATING RISK

Budget 2018's modest surpluses are heavily dependent on successful savings initiatives at the ICBC. Sizable losses at ICBC are projected to narrow the province's overall operating surplus in fiscal 2018 and pressure results beyond then. In fiscal 2017, ICBC's roughly C$600 million operating loss for 12 months (or over $C900 million for 15 months) was its second consecutive deficit after at more than a decade of surpluses. For fiscal 2018, the province projects a record-high $1.3 billion operating loss at ICBC. The losses have reportedly been driven by several factors including a rising number of crashes, significantly higher costs associated with resulting injury claims, and annual basic rate increases that failed to meet growing costs.

In Budget 2018 the government proposes policy changes including limiting payouts for minor injury claims, diverting more claims to a civil resolution tribunal rather than the courts, and adjusting insurance rates. Together, the government estimates the changes will reverse a projected C$800 million to C$1 billion ICBC annual deficit into a narrow operating surplus by fiscal 2021. Absent the ICBC changes and any offsetting budgetary measures elsewhere, the province projects it would end with overall operating deficits ranging from C$173 million to C$716 million over the fiscal plan (including the annual forecast allowances of C$300 million to C$600 million). Failure to fully achieve projected ICBC savings could negatively pressure Fitch's assessment of the province's fiscal performance. Fitch anticipates the province would take offsetting fiscal measures elsewhere in the budget, mitigating the risks.

BUDGET 2018 HIGHLIGHTS NEW INITIATIVES

Budget 2018 makes significant investments in several policy areas, most prominently healthcare, housing, and childcare. Funding comes from new and expanded taxes, and economic growth. On healthcare, Budget 2018 eliminates Medical Services Plan (MSP) premiums on Jan. 1, 2020. This follows the premium reductions announced in Budget 2017 Update, which took effect this year.

To mitigate the revenue loss, the government will implement a new employer health tax, on Jan. 1, 2019. In fiscal 2017, the province collected C$2.6 billion of such revenues. The government estimates the new employer health tax will generate C$1.9 billion annually in fiscal 2020 and 2021. The roughly C$700 million difference is absorbed in the rest of the province's annual C$50 billion - C$60 billion fiscal plan through projected revenue growth and reduced spending in other areas.

Improving the availability of affordable housing and childcare are two other key policy goals outlined in Budget 2018. The government will use new and expanded property-related taxes as a key source to fund related operating and capital spending. With the property-related tax changes, the government intends to both raise new revenue and moderate the price growth of housing. Levying new taxes and expanding existing ones could have unpredictable effects on housing markets like Vancouver.

EXPENDITURE PRESSURES IN HEALTHCARE AND LABOR

Fitch continues to view overall healthcare spending as a key point of potential expenditure pressure for the province. Health accounts for approximately 40% of total provincial spending. Budget 2018 forecasts a steady average annual growth rate between fiscal 2019 and 2021 of 3.4%.

Another key factor in expense management is development of a new mandate to govern labor contracts. Most contracts settled under the prior government's Economic Stability Mandate (ESM) expire by March 2019. ESM included a 5.5% general wage increase spread over five years, with the potential for additional raises tied to the province's economic performance. Three such economic stability dividends have been paid out.

Implementation of a new fiscally prudent mandate for expiring labor contracts will be an important factor in the province's ability to maintain fiscal balance over the medium term. The province announced in recent weeks its first four tentative settlements under a new Sustainable Services Negotiating Mandate (SSNM). No details regarding terms of the mandate, or the tentative settlement agreements, are available yet. Press accounts indicate the tentative agreements include annual wage increases, with additional targeted increases for certain positions where recruitment or retention has been challenging.

Budget 2018 does include a line item for spending on 'priority spending initiatives and caseload pressures' totaling C$2.6 billion over fiscal years 2020 and 2021. This is roughly equivalent to the fiscal prudence measures noted above over those years. SSNM funding could derive at least partially from these funds, which eases fiscal challenges.

RATING SENSITIVITIES
ONGOING FISCAL BALANCE: British Columbia's ratings are sensitive to shifts in the province's commitment to maintaining balanced fiscal operations over the fiscal plan outlook period as economic growth continues. Successful implementation of savings measures around the Insurance Corporation of British Columbia will be a key driver.

CONTINUED CAREFUL DEBT MANAGEMENT: The province has demonstrated prudent debt oversight. Rapid growth in debt, for example related to the currently self-supporting BC Hydro projects, could challenge credit stability if not adequately mitigated.

Contact:

Primary Analyst
Eric Kim
Director

+1-212-908-0241
Fitch Ratings, Inc.
33 Whitehall St.
New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Laura Porter
Managing Director
+1-212-908-0575

In addition to the sources of information identified in Fitch's International Local and Regional Governments Rating Criteria, this action was additionally informed by information from Statistics Canada and the Canada Department of Finance.

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
International Local and Regional Governments Rating Criteria - Outside the United States (pub. 18 Apr 2016)
https://www.fitchratings.com/site/re/878660