January 14, 2016

Dear [Redacted],

Re: Your request for access to information under Part II of the Access to Information and Protection of Privacy Act [Our File #: FIN-46-2015]

On December 23, 2015, the Department of Finance received the following request for access to information:

“Briefing materials -- in any and all formats, including paper and electronic -- prepared for, and/or provided to, the minister related to the province's current and future status in the federal equalization program. Date range of request is Nov. 1, 2015 to the present.”

I am pleased to inform you that your request for information has been granted in full and is provided in the attached.

The responsive records will be published following a 72 hour period after the response is sent electronically to you or five business days in the case where records are mailed to you. It is the goal to have the responsive records posted to the Office of Public Engagement's website within one business day following the applicable period of time. Please note that requests for personal information will not be posted online.

If you have any further questions, please feel free to contact the undersigned by telephone at 709-729-2082, or by email at bethbartlett@gov.nl.ca.

Sincerely,

Beth Bartlett
ATIPP Coordinator

Attachment
Information Note
Department of Finance

Title: The impact of falling oil royalties on the Equalization status of NL

Issue: To provide a brief explanation of the impact falling oil royalties could have on the possibility of NL qualifying to receive federal Equalization payments

Background and Current Status:

- When oil royalties surpassed $1 billion for the first time in 2007-08 ($1.8B), NL ceased to be an Equalization (EQ) recipient the following year, 2008-09. However, if NL oil royalties fall now to levels where NL previously also received EQ, it is uncertain NL would again qualify to receive EQ. At a minimum, it would take several years of low oil royalties before NL could potentially qualify.

- The key difference between the time NL ceased to be an EQ recipient in 2008-09 and today is that a major reform of the EQ program took place which created a very different program that among other things significantly changed the EQ treatment of natural resource revenues.

- The design of the EQ program has a long history of being a contentious issue between the provinces and the federal government. Since its inception in 1957 EQ has generally been on a renewal cycle where the federal government legislates the program for five year periods. Between renewals, there is a formal federal-provincial-territorial collaborative process of reviewing the program. Because the program is so complex, and is so prone to disagreement on how it should operate, significant changes at renewals are not unusual.

- The design of the program became so contentious that in 2005 the federal government established an Expert Panel to review and make recommendations on the future of the program. The Expert Panel reported in 2006 and the federal government reformed the program in 2007.

- The treatment of natural resource revenues has always been one of the most contentious issues for the EQ program, and this is still true today. In part to mute criticism of the new EQ formula, the federal government allowed provinces to continue to have their EQ entitlement calculated under the old formula or to opt-in to the new formula, with the proviso that once a province opted-in to the new formula that decision was irreversible and eliminated the possibility of ever again returning to the old formula.

- For NL, the choice of whether to stay with the old formula or opt-in to the new formula was an exercise of optimizing revenues from the 1985 and 2005 Offshore Accords, which phased out over the four year period from 2008-09 until 2011-12. The optimization strategy for NL necessitated staying under the old program when NL ceased to be an EQ recipient in 2008-09.

- The optimization strategy did require NL to later opt-in to the new formula before the Accords expired in 2011-12. To qualify for EQ today, NL would now be governed by the new formula as reformed in 2007.
Analysis:

- The old program was much more responsive, in terms of the timing of the impact on entitlements, to changes in provincial fiscal capacity, the basis of the EQ formula. The new formula places much greater emphasis on predictability over responsiveness. This means changes in the fiscal capacity of provinces are assimilated into the new formula at a much slower pace than the old formula. Because of this, NL stopped receiving EQ soon after oil royalties escalated, but there would be a longer delay now in NL re-qualifying as an EQ recipient if our fiscal capacity fell under the average of all provinces.

- The new formula is based on a three year moving average of fiscal capacity with a two year data lag. This means, for example, that the decline in fiscal capacity for NL caused by falling oil royalties in 2015-16 would not enter the EQ formula until 2017-18, but any EQ entitlement calculation for 2017-18 would also include the fiscal capacity for NL from 2014-15 and 2013-14, when oil royalties were relatively strong, as components of the three year moving average.

- For NL to again become an EQ recipient would likely require NL to have three successive years of low oil royalties and hence three years of diminished fiscal capacity to enter the EQ formula. Because of the two year lag before current year data is incorporated into the EQ formula it would be 2019-20 before NL had three years of low fiscal capacity caused by the decline in oil royalties enter the EQ formula.

- The uncertainty about whether NL could re-qualify for EQ in 2019-20 is complicated by the fact the EQ formula is up for renewal on April 1 of that year. It is not possible at this time to foresee what changes may be made to the EQ program in 2019-20, but several substantial changes are being investigated, including to the treatment of natural resources. If the federal government acted on likely recommendations from federal officials, the changes could diminish substantially the possibility of NL re-qualifying at that time.

- Forecasting if/when NL could again receive EQ, and how much it could receive, is a function of the fiscal capacity of NL, as measured by the EQ formula, relative to all other provinces. It requires forecasting not only our fiscal capacity, but forecasting the fiscal capacity of all provinces over multi-year time horizons, as well as forecasting the possible impacts of potential changes to the formula at renewals. The huge challenge this presents is well understood by all jurisdictions, none of whom possess a reliable EQ forecasting model, including the federal government who administer the program.

Action Being Taken:

- The Department of Finance will continue to participate in the federal–provincial–territorial process examining the EQ program that will culminate in the 2019 renewal, and will advise on developments.

Prepared/Reviewed by: C. Butt/C. Martin
Approved by: D. Brewer

December 10, 2015