MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Newfoundland and Labrador's ratings to A1, outlook changed to stable

24 Jul 2019

Toronto, July 24, 2019 -- Moody's Investors Service today downgraded to A1 from Aa3 the long-term senior unsecured debt ratings of the Province of Newfoundland and Labrador. The outlook was changed to stable from negative. Concurrently, Moody's lowered the province's baseline credit assessment (BCA) to a3 from a2.

Downgrades:

..Issuer: Newfoundland and Labrador, Province of

....Senior Unsecured Regular Bond/Debenture, Downgraded to A1 from Aa3

....Underlying Senior Unsecured Regular Bond/Debenture, Downgraded to A1 from Aa3

....Senior Unsecured Shelf (Foreign Currency), Downgraded to (P)A1 from (P)Aa3

Outlook Actions:

..Issuer: Newfoundland and Labrador, Province of

....Outlook, Changed to Stable from Negative

RATINGS RATIONALE

The downgrade of the BCA to a3 and long-term debt ratings to A1 reflects Newfoundland and Labrador's elevated debt and interest burdens and continued expectation of material consolidated deficits over the next 2 years. The downgrade also reflects heightened credit risk stemming from the large debt level and weak financial metrics of Nalcor, the province's wholly owned utility, which raises the likelihood the province will need to provide financial support to, or assume debt service from, Nalcor.

Moody's expects that the province's debt burden, expressed as net direct and indirect debt as a share of revenue, will continue to rise in the near-term, peaking at 257% of revenue in 2021 before stabilising around 250% by 2022, up from the expected 227% as of March 31, 2019. This level is elevated among Canadian and international peers and is higher than previously forecasted by Moody's.

The increase in debt burden corresponds to continued financing requirements stemming from ongoing consolidated deficits, which are expected to deteriorate in 2019/20 and 2020/21 before returning to an improving trend. Consolidated deficits are now expected to average 7.3% of revenue before the province's planned return to balanced budgets in 2022/23, higher than previously forecasted. Moody's notes that the province's budget path relies on expenditures falling 7.3% between 2019/20 and 2022/23, which is a highly ambitious target for a Canadian province. Although Moody's notes that the province has been able to keep expense growth tight at 0.8% annually since entering the current period of consecutive deficits in 2012/13, it has not succeeded in achieving two consecutive years of annual expense declines.

Newfoundland and Labrador records the highest interest expense among Canadian provinces. As of March 31, 2019 this metric measured 12.8% of revenue and Moody's expects this to rise to 14.9% by 2022, which will add to budgetary pressure.

The province faces higher levels of volatility surrounding revenues relative to other provinces, given material levels of revenues stemming from specific offshore oil projects. This volatility hampers long-term planning relative to other Canadian provinces and is an intrinsic credit negative of the province.

Finally, the A1 rating reflects Moody's revised assessment of the risk stemming from Nalcor, which accounts for over one-third of the province's total direct and indirect debt but which Moody's currently excludes from the province's net direct and indirect debt measure. Moody's notes that the financial health of Nalcor is weak following the construction of the CAD12.7 billion Muskrat Falls hydroelectric dam project and will remain weak over the medium-term due to a forecast of low revenue growth. In addition to the possibility that the province may have to inject equity into Nalcor or assume some debt to restore its financial metrics, Moody's also takes into consideration that rate mitigation efforts, proposed by the province to ensure hydro rates remain relatively affordable despite the high cost of Muskrat Falls, may require direct provincial support. Moody's notes that the province has a detailed plan that could result in rate mitigation without provincial intervention; however, this plan fails to alleviate Moody's concerns over Nalcor's financial health nor impact on the economy as these measures are not yet implemented nor have they been proven to be sufficient. Should rate mitigation efforts not succeed, either the province would have to offer support to Nalcor or electricity rates would need to rise which would hinder economic activity across the province. Both of these outcomes would be credit negative.

The A1 rating takes into consideration the a3 BCA assigned to the province, along with a high level of extraordinary support from the Government of Canada (Aaa stable).

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook on Newfoundland and Labrador's rating reflects Moody's forecast that although the province is expected to continue to post consolidated deficits which will require debt accumulation, the pace of this will moderate and result in a stabilization of the province's debt burden over Moody's forecast horizon. Similarly, with a slowing of debt issuance, the province's interest expense will also stabilize at levels that remain consistent with the rating. The outlook also reflects that the liability of Nalcor will not materially deteriorate relative to current forecasts over the next 2 years.

WHAT COULD CHANGE THE RATINGS UP/DOWN

Upward pressure could arise if Newfoundland and Labrador's debt burden (expressed as net direct and indirect debt relative to revenue) were to decline to below 230% and interest expense remain below 14%. Upward pressure could also arise if Moody's were to determine that the risks surrounding the province's likely support of Nalcor were to be reduced, either through proven success of rate mitigation efforts without requiring provincial support or through improved financial metrics of Nalcor.

Downward pressure could arise if Newfoundland and Labrador's debt burden were to face continued material increases beyond Moody's forecasts or if the province's fiscal metrics were to materially weaken, reflected in a failure to meet budget targets. Downward pressure could also arise if the financial health of Nalcor were to deteriorate and/or additional financial support from the province were to be required, either directly to Nalcor or indirectly through taxpayer-supported assistance on electricity rates.

The principal methodology used in these ratings was Regional and Local Governments published in January 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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