Reflections of the Auditor General

The following comments are made further to my audit of the Public Accounts of the Province for the year ended 31 March 2005. The Report provides additional information on the financial condition of Government measured by using indicators issued by the Canadian Institute of Chartered Accountants. The Report also offers comments on Government's compliance with generally accepted accounting principles and adherence to principles of sound financial accountability.

Financial Condition of Government

The annual surplus or deficit shows the extent to which a government spends less or more than it raises in revenues in one fiscal year - it shows if a government is living within its means. The accumulated deficit or surplus is the sum of all annual deficits and surpluses. In the Public Accounts, the net debt is the total of all liabilities (e.g. borrowings, group health and life insurance retirement benefits, unfunded pension liability) less financial assets (e.g. cash and receivables).

Reality of Current Financial Condition has to be Considered

There seems to be a sense of optimism that recent developments related to the new Atlantic Accord Agreement and increased oil revenues will continue to provide improvements in the Province's fiscal performance. While this may be the case, especially with recent projections of a modest surplus for 2006, we must not lose sight of past deficits, and enormous debt and debt expenses that we still face in this Province.

To put the financial condition in perspective I report that, at 31 March 2005, the Province had:

- A deficit of $489 million which means that, with the exception of 1998, Government has reported an annual deficit every year since 1994, the first year consolidated summary financial statements were prepared. These deficits have to be either paid or refinanced. We have been borrowing to pay for our deficits and, therefore, our debt continues to grow.

- A net debt of $11.9 billion which results in:

    - the highest net debt per capita of any province in Canada - approximately $23,000 for each Newfoundlander and Labradorian;
    - the highest net debt as a percentage of GDP of any province in Canada at 60.8%; and
    - the lowest credit rating of any province in Canada.

- Debt expenses totaling $940.2 million which results in:
    - the highest interest costs as a percentage of total revenue of any province in Canada at 21%; and
    - fewer resources to allocate to programs and services as a result of the "interest bite".

Long-term Debt Reduction Planning Essential

Because of the annual recurring theme of deficits in the Province, there has been much discussion and focus on deficit reduction and elimination. However, the Province still has billions of dollars in debt along with the resulting significant interest bite. Significant annual surpluses and a reasoned plan of debt reduction will be required if progress is to be made in eliminating this debt. By way of illustration, consider that the Province would require a surplus of nearly $300 million each year for 40 years to eliminate its current net debt of $11.9 billion. As debt decreases debt expenses will reduce, leading to a lower interest bite and more funding available for Government programs.

It is encouraging that Government has made progress regarding the annual deficits. However, the preceding financial indicators clearly show that prudent fiscal management has to continue and a debt reduction plan has to be developed and followed before the financial condition of the Province is turned around.

Fluctuating World Oil Prices Need Close Attention

Volatility relating to world oil prices is now becoming an issue for this Province. Given the Province's increasing dependence on oil revenues, Government's fiscal performance will continue to be significantly influenced by the impact of changes in world oil revenues. Oil prices are highly volatile and, therefore, changes in these prices can result in significant variances between budget forecasts and actual. To illustrate, in 2006, budgeted oil revenues are $215.4 million while mid-year projections are $544.4 million, and in 2005, budgeted oil revenues were $121.4 million while actual was $264.7 million. Therefore, it is important for Government to continue to provide updates on an ongoing basis as significant variances occur.

I will, on behalf of all Members of the House of Assembly, continue to monitor Government's fiscal performance and report annually as to whether progress is being made to bring the Province's finances in order.

$2 Billion Atlantic Accord (2005) Advance Payment

In July 2005, under the Atlantic Accord (2005), the Province received a $2 billion advance payment from the Government of Canada as a 100% offset against reductions in Equalization payments resulting from offshore resource revenues. The $2 billion related to an eight year period to 2012. To date, Government has placed the money in temporary investments and, as at 18 October 2005, earned a total of $15.4 million on interest rates varying from 2.6% to 3.03%.

However, the Province currently pays approximately 7.5% on its unfunded pension liability and interest rates ranging from 5.25% to 11.625% on its debenture debt. While Government has various options (spend or pay-down debt) for utilizing the $2 billion, significant savings could be realized by reducing the Province's debt. While debenture debt typically does not permit early pay-down, monies could be paid against the unfunded pension liability. To illustrate, there is a spread of at least 4.5% (7.5% - 3.03%) between what was earned with the money versus what was paid on the unfunded pension liability. This 4.5% on $2 billion would result in annual interest savings of $90 million or $7.5 million per month.

Retirement Benefits - Pensions

At 31 March 2005, the unfunded pension liability totalled $3.93 billion and continues to be a significant issue for Government. The unfunded pension liability increased by $188.1 million during the year, a 5.0% increase from the $3.75 billion balance at 31 March 2004. Since the early 1990s, the unfunded pension liability has almost doubled.

In 1998, in an attempt to address the unfunded pension liability, Government started to make special payments into the pension fund. Since 1998 Government has made special payments totalling $1.2 billion. However, these special payments are not large enough to reduce the unfunded pension liability - in fact the unfunded liability continues to grow. To put this into perspective, for the year ended 31 March 2005 Government made a special payment of $156 million to the pension fund; however, even with this significant special payment the unfunded pension liability increased by $188.1 million. Interest costs alone on the unfunded pension liability during the year amounted to $320.6 million (i.e. $164.6 million more than the special payment made by Government in an attempt to address the unfunded pension liability).

Of particular note is the Teachers' Pension Plan. Even with Government's special payments, the Province's actuary has indicated that the Teachers' Pension Plan is expected to run out of funds in 2014. The Fund will decline annually and the negative cash flow (deficiency) will then become the amount Government will have to pay in order for plan members to receive their pensions. The initial deficiency amount Government will have to pay is $196 million and this deficiency amount will increase to a maximum to $255 million in 2026.

Addressing the unfunded pension liability should remain a priority for Government.

Retirement Benefits other than Pensions

Government provides retirees with group health and life insurance benefits. At 31 March 2005 the Province's net liability for these retirement benefits was $1.159 billion. This liability has added to the already considerable debt load of the Province and, if action is not taken to address it, is expected to increase in each of the next four years. By 2009 the liability is expected to total $1.552 billion, an increase of $567 million or 58% over the $985 million liability for 2003, when the liability was first recorded.

Government should carefully manage its liability relating to group health and life insurance benefits.

Accounts Receivable

Government has historically focused on expenditures and not revenues. The lack of focus on revenues is a contributing factor in why Government does not do a good job in collecting amounts owed to it and, therefore, a significant portion of its receivables have either been written off or are considered doubtful of collection. At 31 March 2005 Government departments were owed $471 million of which $259 million (55.0%) has been outstanding in excess of one year and $180 million (38.2%) is considered to be uncollectible. In addition, since the early 1990s, Government has written off a total of $321 million in accounts receivable.

Although Treasury Board indicated in 2002 that initiatives would be undertaken in an effort to improve collection of accounts receivable, the initiatives have not been fully implemented. The Department of Finance was to establish a Central Provincial Collector function to provide assistance and training to departments in their collection efforts; however, this is still not in place. In addition, Treasury Board directed departments to document policies and procedures relating to the collection of accounts receivable; however, three departments (Environment and Conservation, Health and Community Services, and Education) have not documented their accounts receivable procedures.

Government should be more diligent in collecting amounts owed to it and take action to implement all initiatives identified by Treasury Board to improve collection of accounts receivable.

Environmental Liabilities

In my 2002 Annual Report to the House of Assembly I concluded that *"There is no central inventory of contaminated sites. The lack of a central inventory makes it more difficult for Government to determine the nature and extent of contaminated sites in the Province, the extent of progress of remediation efforts, and estimated future remediation costs to be incurred by Government."*

There is still no complete central inventory of contaminated sites and there is no liability recorded on the Province's financial statements for remediation costs associated with these sites. The only information currently noted in the financial statements is found in Note 8 (c) (vi) which states that *"…while the Province is aware of a number of contaminated sites, the full extent of the remediation costs for these known sites is not readily determinable"*. I note that a report made public by Government in January 2004 referred to an estimated cost of $237 million relating to the remediation of contaminated sites.

Government should undertake a process to identify all contaminated sites in the Province for which it is potentially liable, determine its share of remediation costs and record any resulting liability in the Province's financial statements.

Government Reporting Entity

The Province's Consolidated Summary Financial Statements are required to include all organizations that are controlled by Government. However, Government has never included Memorial University of Newfoundland in the Province's financial statements. My Office has recommended including the University every year since 1994, the first year these financial statements were prepared.

I am pleased to report that Government has approved including Memorial University of Newfoundland in the Consolidated Summary Financial Statements commencing next year - 31 March 2006.

JOHN L. NOSEWORTHY, C.A.
Auditor General

Reflections of the Auditor General