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February 10, 2010

Alberta Budget 2010

Another year of tough slugging

After posting its biggest budget shortfall since the early 1980s in 2009-10 – now forecast at \$3.6 billion – the Alberta government announced yesterday an even bigger deficit projection of \$4.7 billion for 2010-11, a new record. Yet it remains committed to be back in the black in two years, counting on a sharp snapback in revenues (primarily from non-renewable resources and corporate income tax) and tight expense management to do the trick. The deficit is projected to shrink to \$1.1 billion in 2011-12, setting the stage for a small surplus of \$505 million in 2012-13.

The deepening of the deficit in 2010-11 is largely attributable to a significant swing in capital spending and higher operating expenses. Capital grants being expensed are projected to increase by \$213 million (or 5.1%), following a drop of almost \$1.1 billion (or 21%) in 2009-10. Operating expenses will continue to grow strongly (up by \$1.7 billion or 5.6%) – however, a good portion of this increase is related to a one-time \$759 million provision to eliminate Alberta Health Services' accumulated deficit. Higher total expenses will dwarf a small rise of \$423 million in revenues (up 1.3%) – although the latter will be a significant improvement from a huge decline of \$2.3 billion (-6.3%) in 2009-10.

The Alberta government will continue to dip into its Sustainability Fund to offset its deficits in the next two years, staying committed to refraining from borrowing “from future generations to fund operations”. The Fund is projected to decrease from \$15.0 billion at the end of 2009-10 to \$2.8 billion at the end of 2012-13.

Budget highlights

Total revenues are projected to rise by 1.3% in 2010-11 to \$34 billion. Own-source revenues will increase by 1.1% to \$28.9 billion and transfers from the federal government by 2.4% to \$5.1 billion. Total revenues are expected to rebound much more strongly in 2011-12 with a projected growth of 9.8%.

After plummeting by almost 50% in 2009-10, **non-renewable resource revenues** are projected to bounce back by 21.7% to \$7.3 billion, led by royalties from oil (increasing by 47% to \$5.4 billion). Royalties from natural gas are also forecast to rise but by a smaller magnitude (up 7.0% to \$1.9 billion). The improvement in non-renewable resource revenues reflects stronger oil and gas prices, as well as a 16% expected increase in non-conventional oil production (in terms of volume). The rebound is being tempered by the cost of the drilling stimulus initiatives (subtracting \$732 million in 2010-11) announced in March 2009. The Alberta government assumes a crude oil (WTI) price of US\$78.75/barrel in 2010-11 (fiscal calendar) and US\$83.50 in 2011-12, up from US\$69.95 in 2009-10. The natural gas price (Alberta reference point) assumptions are C\$4.25/GJ in 2010-11 and C\$5.25 in 2011-12, up from C\$3.40 in 2009-10.

By contrast, **investment income** is not expected to show any improvement in 2010-11. In fact, investment income from the province's various funds and agencies is projected to decline by close to 44%, based on “more moderate” market returns following what the government

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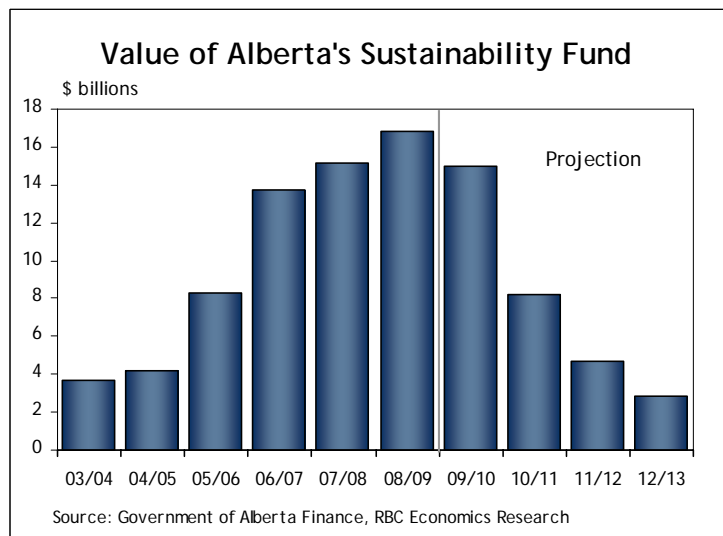
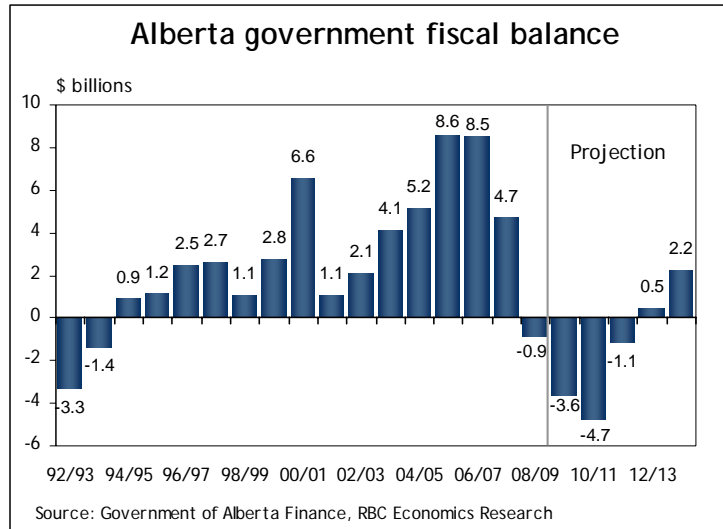
deems as an exceptional performance in 2009-10. A sharp rise occurred mainly as a result of positive asset revaluations (in turn, representing partly the reversal of significant devaluations the previous year).

Corporate income tax is projected to decline again, down 5.7% to \$3.1 billion on the heels of a whopping 22.4% drop in 2009-10. This reflects the lingering effect of the recession and downturn in the resource sector on corporate profits in the province. However, there should be some meaningful improvement by 2011-12 when a strong 21.8% increase is projected.

Base revenue from the **personal income tax** is expected to grow by 4.7% to \$8.6 billion in 2010-11, benefiting from a gradual recovery in the job situation in the province. This growth is seen to accelerate to 7.2% in 2011-12.

Total operating expense will increase by 5.6% to \$32.1 billion in 2010-11. The bulk of the increase will reflect a 16.6% boost to Health and Wellness (budgeted at \$14.9 billion). Under a new five-year funding agreement, the provincial government will provide additional funds to Alberta Health Services both to eliminate agency's accumulated deficit in 2009-10 and adjust upwards the agency base operating grant. This will amount to \$1.7 billion in 2010-11. Education also will receive a 4.7% rise in its budget (to \$5.6 billion). Partly offsetting these increases will be cuts in a number of ministries including Advanced Education and Technology.

Total **capital spending** will ramp up by 5.4% to \$7.2 billion in 2010-11, after a substantial decline of almost 10% in 2009-10. This spending is composed of capital grants (up 5.1% to \$4.4 billion) and capital investment (up 5.9% to \$2.8 billion). However, the **three-year Capital Plan** (2010-13) has been slashed to \$20.0 billion compared to the previous 2009-12 plan of \$23.2 billion. This reflects downward revisions to years one and two, as well as a further decline in spending in year three.



Commentary

The wild ride in energy prices in the last two years and its impact on various sectors of the Alberta economy has made it particularly difficult to nail down the revenue side of the provincial budget recently. Yesterday's budget documents candidly admit that it has been a tough year to accurately forecast key sources of revenues and this has transpired in the many revisions that have taken place in the past year. The forecast for the 2009-10 deficit began at \$4.7 billion in the 2009 budget last April. It was first boosted in the first quarter fiscal update to \$6.9 billion. Then it was revised lower to \$4.3 billion in the second quarter update. Finally, in yesterday's 2010 budget, the deficit was cut once more to \$3.6 billion. This volatility underscores how sensitive a highly commodity-dependent province such as Alberta is to wide-swinging commodity markets. Given the nature of the beast, some volatility must again be expected with respect to the 2010-11 numbers.

That being said, we take heart that the assumptions used in the fiscal projections are generally conservative, which might point to some upside for revenues (downside to the deficits). The provincial government forecasts real GDP at 2.6% this year and 2.9% in 2011, matching our forecast in 2010 but undershooting the 4.4% we have for 2011. Price assumptions for crude oil are slightly more conservative than RBC's forecast (US\$80/barrel in 2010 and US\$90/barrel in 2011), and significantly more so this year in the case of natural gas (the government projects the Henry Hub benchmark to average US\$4.71/mmbtu this year and US\$6.03/mmbtu in 2011 compared with RBC's averages of US\$5.50/mmbtu and US\$6.50/mmbtu, respectively). Using RBC's natural gas forecast would bring in more than \$700 million in higher revenues.

With such conservative assumptions, we can hope that any volatility this year will be on the side of improvement.



Alberta's fiscal plan

\$ billions	Actual	Forecast	Estimate	Target	Target
	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>
Revenue	35.8	33.5	34.0	37.3	40.2
Expense	36.7	37.2	38.7	38.4	39.7
Surplus/ (deficit) before correction	-0.9	-3.6	-4.7	-1.1	0.5
Withdrawal from Sustainability Fund	0.9	3.6	4.7	1.1	-
Adjusted Surplus	-	-	-	-	0.5

Source: Government of Alberta Finance, RBC Economics Research