ALBERTA BUDGET 2011

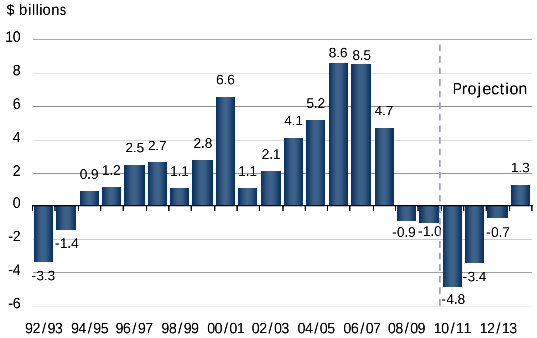
February 25, 2011

Alberta's deficit shrinking but will persist longer

The controversial Alberta budget was released yesterday and looked largely as expected. The centre of the recent political storm in the province – which led both Premier Ed Stelmach and Finance Minister Ted Morton to resign - was the timeline for the return to surplus, which was extended by one year to 2013/14. This was largely the result of revisions to revenues due to lower-than-expected natural gas prices and a strong dollar. Nonetheless, with a provincial election looming in 2012, the medium term budget plan could be altered by a new government with different fiscal priorities.

The deficit planned for 2011/12 is now $3.4 billion, down from $4.8 billion shortfall in 2010/11 but up substantially from the $1.1 billion forecast figures for 2011/12 presented in last year's budget. Upward revision relative to the previous projection reflects a $1.7 billion drop in expected revenues arising principally from a $1.0 billion downward adjustment to natural resource royalties. This in turn is the result of significant changes in the expected price of natural gas (which is now expected at C$3.45/GJ as opposed to the C$5.25/GJ planned in the 2010/11 budget) and to the continued strength of the Canadian dollar (now expected at US$0.98 vs. US$0.95 in the previous budget.) A $1/GJ decline in natural gas translates into a net drop of more than $500 million in provincial revenues. The province will again draw on its Sustainability Fund to finance the deficit, and will maintain most planned operating and capital expenditures. Projections for 2012/13 and beyond show rapidly increasing revenues and moderate expenditure growth, returning the province to surplus by 2013/14. It is noteworthy that, contrary to other provinces, Alberta does not build in specific allowances for forecast misses, relying instead on transfers from their reserves to make up any shortfall.

Alberta government fiscal balance



Source: Government of Alberta Finance, RBC Economics Research

Budget highlights

Total revenues are expected to increase to $35.6 billion or 4.7% in 2011/12. Most of this increase comes from improved personal income tax receipts (expected to be up 16% over last year), although corporate income taxes and resource royalties are also expected to rise. The budget predicts a 10% decrease in federal transfers in 2011/12 due to the end of stimulus funding, with small increases in the following two years. Renegotiation of the Canada Health Transfer and Canada Social Transfer in 2013/14 provides some risk for the forecast in that year. While direct taxes are not being raised, the government is introducing fees for some services and cancelling the fuel rebate for licensed vehicles, contributing $151 million in higher revenues. Tax receipts and royalties are expected to increase further in 2012/13 and 2013/14, leading to predicted total revenue growth of 9.1% and 8.2%, respectively.

Total expenses are up 0.5%, rising to $39.0 billion in 2011/12. The low rate of growth in total expenditures arises mainly from a large decline in the "other expenses" category, reflecting unusually high one-time expenditures

Kirsten Cornelson
Economist
(416) 974-8593
kirsten.cornelson@rbc.com

in 2010/11 due to emergency flood relief not being repeated in the coming year. Operating expenditures are up by 2.2%, reflecting ongoing investments in healthcare (up 4.6%, excluding last year's special Alberta Health Services deficit grant) and education (up 4.5%.) The budget predicts expenditure growth of 2.2% in each of the following two fiscal years.

Capital spending is up 6% in 2011/12 or $371 million over 2010/11, and will reach $6.6 billion. This includes a small increase in capital grants (included in expenses) combined with $339 million in new capital investment. The government's three year capital plan for 2011-14 involves $17.6 billion in spending, which is a reduction from the $20.1 billion budgeted for 2010-2013. This reduction reflects lower spending on roads and education which will only be partly offset by slightly higher spending on hospitals.

Sustainability Fund withdrawals will be $5.9 billion in 2011/12, leaving the Fund with $5.3 billion at year end. To put this in perspective, this will be about one third of the balance at the beginning of 2008/09. The biggest components of the transfer are $3.4 billion to cover the deficit and $2.2 billion in cash adjustments to cover part of the capital investment (the rest will be borrowed from external sources.) In the absence of significant changes to the medium term projections, continued deficits are expected to draw down most of the remaining balance in the Fund over the next two years, leaving it with just $1.7 billion in assets at the end of 2013/14.

Still leader of the pack

The rosy revenue outlook depends in part on anticipated strength in oil prices, which the budget forecasts at US$89.40/bbl in 2011/12 and US$95.50 in 2012/13. These numbers are generally in line with our own forecasts of USD$87 in 2011 and USD$90.00 in 2012 (note that these are prior to the unrest in Libya.).On the other hand, the Budget's projected natural gas prices are low compared to most private sector forecasts. The government's real GDP growth projections are also on the low side: 2.9% for the province in 2011 and 3.0% in 2012, compared to our 4.3% and 3.8%, respectively. Therefore, we believe that the assumptions used to generate revenue predictions are fairly conservative and the government is likely to meet or exceed its revenue targets.

The projected growth in expenditures of 0.5% in 2011/12 and 2.2% over the following two years is aggressive by recent standards: program expenditure growth averaged more than 10% per year in the six years prior to the recession. These growth rates are also slower than inflation plus population growth (3.3%, 3.9% and 3.9% in 2011/12, 2012/13 and 2013/14, respectively), implying significant fiscal restraint. However, we believe that revenue strength should be sufficient to compensate for any minor slippage in expenditures and return the province back to surpluses by 2013/14.

Despite the political acrimony surrounding the budget, it is worth keeping in mind that Alberta's finances are in relatively good shape by the standards of any other province. Even at its worst point in 2010/11, Alberta's deficit-to-GDP ratio remained well below those in Ontario and Quebec. While the reductions in the Sustainability Fund might seem dramatic, the purpose of the Fund is to protect the province against the volatility generated by reliance on resource revenues, which is a principal source of the current fiscal shortfall. The province's strong net asset position combined with solid expected growth mean that Alberta should be able to regain its fiscal footing in a relatively short period of time.

Alberta's fiscal plan

$ billions	Actual	Forecast	Estimate	Budget 2011 Target	
	2009-10	2010-11	2011-12	2012-13	2013-14
Revenue	**35.7**	**34.0**	**35.6**	**38.8**	**42.0**
Expense	**36.7**	**38.8**	**39.0**	**39.5**	**40.7**
Program expense	36.3	38.3	38.4	38.9	40.1
Debt servicing costs	0.4	0.5	0.6	0.6	0.6
Surplus/ (deficit) before correction	**-1.0**	**-4.8**	**-3.4**	**-0.7**	**1.3**