

Fiscal Year 10/11

As the Deficit Turns

Michael Gregory, CFA
Senior Economist

Robert Kavcic
Economist

February 9, 2010
5:00 pm

The Province of Alberta is projecting a \$4.7 billion deficit for the fiscal year ended March 2011, after an estimated \$3.6 billion shortfall in FY2009/10. The latter deficit was revised down from the prior (Nov-09) estimate of \$4.3 billion and last year's Budget projection of \$4.7 billion, mainly due to stronger-than-expected investment income. However, despite the improvement to this year, next year's \$4.7 billion shortfall is still well above what was projected a year ago: \$2.4 billion after an unallocated fiscal correction of \$2 billion, which is why we remain leery of "measures to be named later". Fortunately, the deficit is projected to shrink to \$1.1 billion in FY2011/12—an impressive improvement upon last year's all-in projection—before returning to surplus as promised in FY2012/13, at \$505 million. The Province will draw from its Sustainability Fund to cover its deficits and other off-budget items. Assets in the fund, accumulated during the surplus years, will fall from an estimated \$15.0

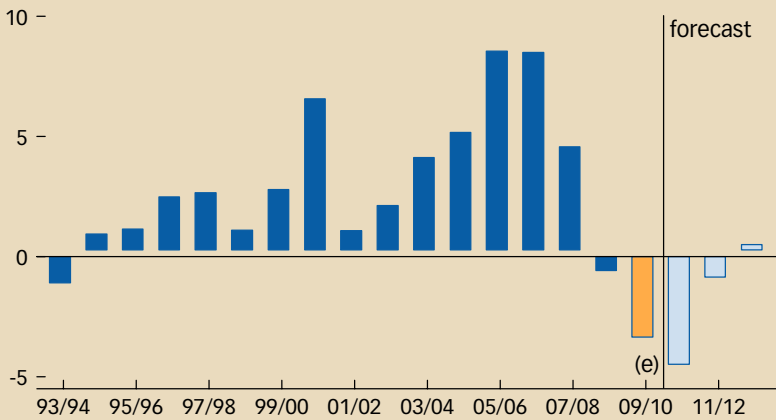
billion next month to \$2.8 billion by FY2012/13.

For the forthcoming fiscal year, total revenue is projected to inch up 1.3% to \$34.0 billion, after falling an estimated 6.3% in FY2009/10 because of commodity price declines. Despite a 22% surge in non-renewable resource revenues (the Province's energy price assumptions are listed in the chart on the next page), next year's total revenue is dragged by lower investment income (-44%). The revenue projection does not incorporate any changes to the royalty regime that could arise from the soon-to-be-published Natural Gas and Conventional Oil Investment Competitiveness Study (the scuttlebutt being that some royalties could be reduced). There were no tax increases announced, and Albertans continue to pay the lowest taxes in Canada.

Total expense is projected to grow 4.2% to \$38.7 billion in FY2010/11, well above the current fiscal year's estimated 1.4% growth, owing to an acceleration in program spending (+3.9% next year vs. just +1.3% estimated for FY2009/10). This mostly reflects higher health care outlays to address a previously underfunded Alberta Health Services. This "catch up" is keeping program spending running in-line with

Budgetary Balance*

(\$ billions)



Source: Provincial forecasts e = estimate
*Before withdrawal from Sustainability Fund

Fiscal Outlook

(C\$ millions)

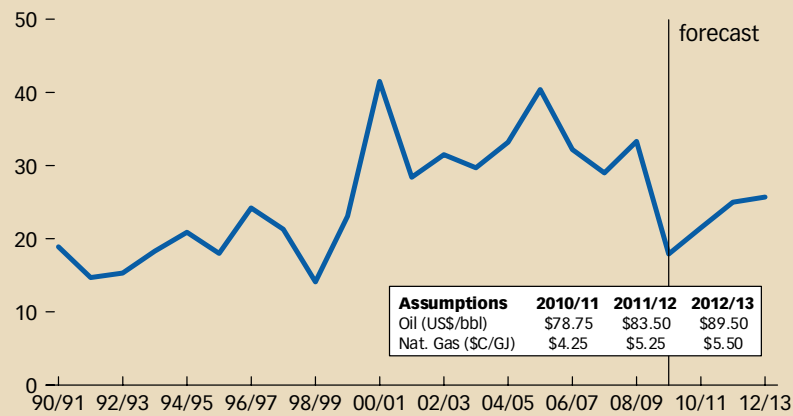
	estimate		—forecast—	
	09/10	10/11	11/12	12/13
Revenues	33,541	33,964	37,302	40,239
Expenditures	37,165	38,712	38,437	39,734
Program Expense	36,942	38,376	38,050	39,326
Debt Service	223	336	387	408
Surplus (deficit)	(3,624)	(4,748)	(1,135)	505

Source: Provincial forecasts

Note: Totals may not add due to rounding.

Resource Revenues

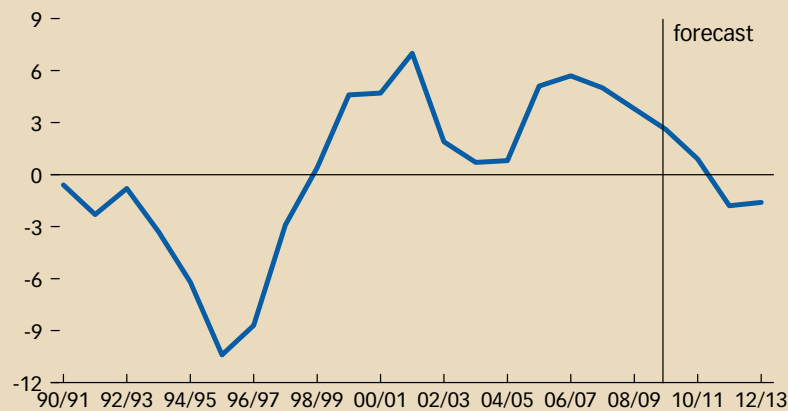
(Share of total revenues, %)



Source: Provincial forecasts

Real Program Spending per Capita

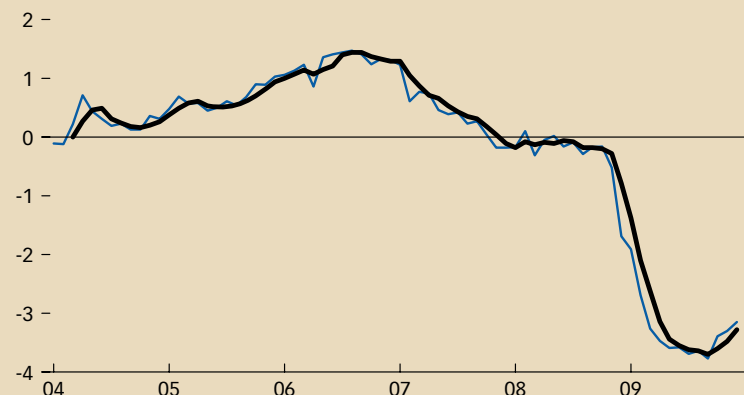
(3-yr annualized % chng)



Source: Provincial forecasts

Provincial Economic Momentum Index: Alberta

(Dark line = 3-mo. avg.)



*The PEMI measures the number of standard deviations economic activity is above or below trend.

projected inflation and population growth (+3.8% combined). Capital spending continues under the four-year plan announced in last year's Budget, although the cumulative total has been clipped to \$20.1 billion owing to lower construction costs—\$7.2 billion is slated for FY2010/11.

Turning to the out-years, the Province's return to surplus in FY2012/13 hinges on a combination of solid revenue growth and a focused effort to contain program spending. Revenue is projected to grow 6.3% annually through FY2012/13, slightly stronger than the 5.3% growth seen during the past decade. This is based on the assumptions that economic recovery is taking hold in the province, which will drive income tax receipts, and that commodity prices will continue to push gradually higher. Indeed, oil and natural gas prices are projected to average US\$89.50 and \$C5.50, respectively, by FY2012/13, pegging resource revenues at 25.7% of total—that's up from the 18% share seen in the current fiscal year, but down from highs of about 40% during the boom years. All told, the Province is banking on a commodity-led economic recovery to take shape in order to hit their revenue targets—we also see that on the horizon.

Meantime, the rate of program spending growth is projected to slow significantly starting in FY2011/12, rising just 2.1% annually over the next three years versus growth of 8% over the past three. Granted, the next few years are unlikely to see the same pace of economic and population growth that was witnessed during the late stages of the commodity boom, which should lower the spending demands. On a real per-capita basis, program spending will fall 1.6% annually over the next three years, a much more modest contraction than the one seen during the mid-1990s slump, but one that still requires discipline.

Revenue is projected to grow 6.3% annually through FY2012/13, slightly stronger than the 5.3% growth seen during the past decade. This is based on the assumptions that economic recovery is taking hold in the province, which will drive income tax receipts, and that commodity prices will continue to push gradually higher. Indeed, oil and natural gas prices are projected to average US\$89.50 and \$C5.50, respectively, by FY2012/13, pegging resource revenues at 25.7% of total—that's up from the 18% share seen in the current fiscal year, but down from highs of about 40% during the boom years. All told, the Province is banking on a commodity-led economic recovery to take shape in order to hit their revenue targets—we also see that on the horizon.

The Alberta economy suffered a difficult year in 2009 amid a sharp reduction in

commodity-sector activity—the combination of falling oil and natural gas prices and a more taxing royalty regime have cut investment activity in the sector by about half in 2009, while land sales and drilling activity both fell sharply. In the wake of the downturn, the Province saw net out-migration for the first time in 15 years in 2009Q3. One positive impact of the recession has been cooling cost pressures in the province (ie: labour and raw materials), which ran out of control late in the recent boom. Now, lower costs and a rebound in oil prices have improved the economics in the Alberta energy sector, and activity should begin to pick up later in 2010. We judge real GDP will grow 3% in 2010, outpacing the national rate, and outperform the national average over the medium term. The Province is forecasting 2.6% growth in 2010 and average growth of 3% through 2013—we deem these forecasts to be achievable.

The table below shows the planned term borrowing of the Province of Alberta (to support capital spending only, and on behalf of provincial corporations) along with its agencies, Alberta Capital Finance Authority and Alberta Treasury Branches. So far in FY2009/10, the Province has raised \$2.7 billion in term debt, with another \$100 million expected to be raised via (retail) Alberta Capital Bonds later this month and another \$61 million in capital markets. For the \$2.5 billion requirement by ACFA in calendar 2010, \$625 million has already been raised.

(\$ millions)	2010/11	2011/12	2012/13
Province of Alberta			
For capital purposes	1,100	709	-
For Agriculture Financial Services Corp.	470	285	220
ACFA (calendar year)	2,500	1,500	1,100
ATB Financial	-	800	1,500

The Bottom Line: Alberta's FY2010/11 budget doesn't immediately begin to chip away at the deficit, a theme we judge will be mimicked among several provincial budgets this year. Instead, the Province is relying on solid revenue growth and a material slowdown in program spending growth in the two subsequent fiscal years to return to budget balance. While the economic outlook should support the Province's revenue forecast, discipline will be required to hit their spending targets.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N.A., and BMO Capital Markets Limited. TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd. TO U.K. RESIDENTS: The contents hereof are not directed at investors located in the U.K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.