

Methodology

*Rating Canadian
Provincial Governments*

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Insight beyond the rating.

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Overview

DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on forward-looking measurements that assess a debt issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) in accordance with the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies consider a broad array of quantitative and qualitative factors that are both industry- and entity-specific. In the case of Canadian provinces, DBRS groups the risk factors into five broad categories listed below in order of importance:

- (1) Economic profile
- (2) Fiscal management
- (3) Debt and liquidity
- (4) Intergovernmental relations
- (5) Political environment

These risk categories form the basic framework for all provincial ratings, with each underlying risk factor assessed by DBRS in a uniform fashion across provinces in order to ensure consistency among ratings.

DBRS rating methodologies are underpinned by a stable rating philosophy. Consequently, DBRS takes a longer-term "through the cycle" view of the issuer, which means that in order to minimize rating changes due primarily to cyclical economic changes DBRS generally factors the expected impact of a normal economic cycle into its rating. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS's analysis is its broad industry coverage, which it undertakes in order to better appreciate the major differences and subtle nuances within a particular industry and to develop a solid understanding of the issuer relative to its peers.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee, as well as the role of the DBRS rating committee as the final decision maker. DBRS rating committees comprise experienced and knowledgeable DBRS personnel and strive to provide objective and independent rating decisions that are based upon all relevant information and factors, incorporate both global and local considerations, consistently apply DBRS approved methodologies and reflect the opinion of DBRS.

The following is a more detailed discussion of the various factors considered by DBRS when assessing the creditworthiness of Canadian provincial governments.

Economic Profile

The economy of a province constitutes a key consideration in the credit assessment of its government, as it is the primary determinant of the capacity of a government to raise the revenue necessary to fulfil its service responsibilities and carry its debt. In its analysis of this risk category, DBRS focuses on the resilience, flexibility and propensity for growth of the economy as well as on any impediments that could foster volatility or impair growth. Outlined below are the primary factors used by DBRS to evaluate the contribution of the economy to the rating of a provincial government.

ECONOMIC STRUCTURE

The composition of a provincial economy provides valuable insight into the volatility, dynamism and growth potential of a province, and its propensity to create jobs and generate wealth. A well-diversified economy with a strong emphasis on value-added industries will generally tend to fare better and experience more consistently robust growth over the longer term than a commodity-based economy. In its analysis of the economic structure, DBRS focuses on (a) gross domestic product (GDP) and employment breakdown by major industry; (b) prospects of key cities, industries and sectors with competitive advantages; (c) track record of employment creation; (d) trade flows; and (e) adequacy of major infrastructure (e.g., roads, electricity generation). Structural distortions within the economy, such as burdensome tax or regulatory systems, are also considered in the analysis.

DEMOGRAPHICS AND SOCIAL STRUCTURE

Demographic and social trends can influence political stability and significantly impact a government's fiscal position by affecting the labour force, income distribution and the demand for social services. For example, provinces with a rapidly growing population will often enjoy an expanding labour force and tax base, but may also face greater popular pressure to expand public services and build appropriate economic infrastructure. In contrast, mature provinces will generally face less capital growth pressure, but their aging population may translate into rising pension and health-care expenditures and a shrinking tax-paying workforce. Demographic and social indicators assessed by DBRS include (a) average age of the population; (b) dependence ratios; (c) migration trends; (d) education attainment; (e) unionization rate; (f) welfare caseloads; and (g) income and wealth distribution.

HISTORICAL GROWTH AND PROSPECTS

A sound record of sustained economic growth is prime evidence of a province's ability to generate wealth for its population and fiscal resources for its government. DBRS looks at the level and trend of key summary indicators and seeks to understand the growth trend and potential of the province in relation to that of the country, as defined by an array of variables, including (a) per capita GDP and income; (b) real GDP and employment growth; (c) labour productivity; (d) private sector investment; and (e) savings rates.

Key Economic Statistics

| | |
|--|--|
| GDP growth trend | Private sector investment |
| GDP per capita | Retail sales growth and savings rates |
| GDP and employment by industry | Housing starts |
| Employment and labour force growth trend | Inflation |
| Unemployment rate | Population growth and migration trends |
| Personal income per capita | Age distribution and dependence ratio |

Fiscal Management

The review of the fiscal management framework is aimed at assessing the government's fiscal sustainability and prospects, looking at revenue generation, spending discipline as well as the coherence and appropriateness of the strategies, policies and processes governing the planning and allocation of public resources. Particular attention is paid to the quality of the fiscal management framework in place, the adequacy of revenues to cover core programs and interest charges, and the level of fiscal flexibility afforded by the system, that is, the degree to which expenditures can be contained or revenues increased in order to protect fiscal soundness. DBRS also analyzes the volatility of fiscal results and the government's fiscal track record, which provides an indication of the government's commitment to fiscal soundness.

BUDGET PLANNING AND EXPENDITURE CONTROL

DBRS reviews the effectiveness of the budgetary process, including the transparency, timeliness and comprehensiveness of the government's planning, reporting and monitoring systems, as well as the ability of fiscal authorities to control expenditures. Additional considerations include the allocation of responsibilities and controls within the government organization, adherence to budget policies (e.g. balanced budget legislation), and the coherence and consistency of social and fiscal policies, with frequent changes in strategic goals generally perceived as weakness in the policy framework.

In assessing the quality of the fiscal planning framework, DBRS compares recent years' fiscal results against original budget estimates, putting emphasis on the frequency and extent of major budget deviations. DBRS also reviews accounting consolidation practices in order to understand the composition of the reporting entity and verify whether all tax-supported activities are appropriately captured.

EXPENDITURES

For this part of the analysis, DBRS distinguishes between three major types of expenditures: programs, capital and debt servicing, with particular emphasis placed on identifying major trends, actual and potential areas of pressures and sources of rigidities.

Through its analysis of program expenditures, DBRS seeks to understand the government's role and service responsibilities in the economy, and the relationship between key expenditure items and factors such as demographics and economic conditions in order to identify potential sources of pressure. Analysts review major government programs, focusing on the coherence and sustainability of each program, and expected cost implications. Reported figures are reviewed to evaluate the treatment of non-recurring items and determine whether all material tax-supported activities within provincial jurisdiction are captured by the reporting entity.

Until recently, capital spending was much more cyclical than program expenditures, as provinces often had recourse to capital spending reductions to balance their budget in times of financial hardship. With the introduction of accrual accounting for capital expenditures in recent years, however, the incentives for deferring capital spending have dropped markedly. This has resulted in smoother capital spending patterns but also in a blurrier relationship between fiscal results and debt changes. Analysts seek to get a clear understanding of current and future capital requirements faced by the government, focusing on the state of good repair of major public infrastructure and on the estimated future costs of maintaining existing assets and addressing growth-related and deferred maintenance needs. Financing methods and accounting rules for capital spending are also reviewed in order to fully appreciate the debt implications of projected capital needs and verify whether accrued costs are reported consistently across provinces.



Of all three expenditure categories, debt servicing is definitely the most rigid and can constitute a substantial portion of a government's budget. As a result, the stability and trend of government interest and debt payments are an especially important consideration. In analyzing debt servicing requirements, DBRS pays attention to the government's debt structure and management strategy, incorporating findings from the analysis of the debt and liquidity profile, which is described later on in this methodology.

REVENUES

The revenue analysis covers the major components of a government's revenue base, focusing on diversification, volatility and ability to grow key sources when needed, as well as the extent of the tax effort imposed on residents and corporations. Key revenue sources for provincial governments include taxation, royalties and user fees as well as federal transfers and earnings from government enterprises.

Special emphasis is put on the resilience of major revenue sources, reliance on federal transfers, and competitiveness of the tax system relative to neighbouring jurisdictions. Potential structural defects in the government's revenue base are also analyzed, as, for example, an inefficient tax system may limit budget flexibility and create distortions in the economy by exacerbating tax evasion, distorting business decision making and discouraging investments.

Note that DBRS may make certain adjustments to reported revenue figures in order to improve comparability across provinces, exclude non-recurring items and, ultimately, better reflect the underlying fiscal situation of the province (see Appendix A for details).

FISCAL BALANCE

Fiscal results are viewed by DBRS as a reliable indicator of management proficiency and commitment to fiscal soundness. Analysts look at the primary balance (revenues minus program expenditures) as the primary indicator of fiscal flexibility, while the overall fiscal balance (net of interest charges) better reflects overall fiscal sustainability and the potential financing requirements in a given year. Analysts examine historical as well as prospective results, focusing on the cyclicity and sensitivity of the budget and financing requirements to adverse developments. While repeated budgetary shortfalls are perceived negatively by DBRS, the impact of a shortfall will generally be discounted if it is believed to be the result of an economic downturn or non-recurring events, as opposed to a structural imbalance about which a government is showing little initiative.

Key Fiscal Management Statistics

| | |
|---|--|
| Surplus or deficit/GDP | Capital spending/GDP |
| Expenditure volatility and trend | Interest charges/total expenditures |
| Actual expenditures/budgeted expenditures | Revenue diversity and stability |
| Expenditures per capita and as % of GDP | Key individual and corporate tax rates |
| Expenditure change/revenue change | |

Debt and Liquidity

The sustainability of a government's debt burden is a central consideration in the determination of the rating. DBRS carefully examines current and projected levels of indebtedness and considers the full range of factors that could affect the debt burden and related servicing requirements.

DEBT

The primary focus is on tax-supported debt, which includes financial obligations for which tax payers are directly accountable. This concept captures tax-supported debt directly issued by the government as well as the financial obligations of all related tax-supported organizations that are within provincial jurisdiction (e.g., universities, school boards, hospitals). Also included as part of tax-supported debt are other financial commitments such as capital lease obligations, unfunded pension liabilities and the debt of municipalities. The resulting debt figure is compared with the capacity to carry debt of the government as represented by the provincial GDP.

Self-supporting debt, which is issued by commercial government enterprises and serviced by distinct user fees (e.g., electric utilities), is analyzed separately by DBRS and generally allocated a much smaller weighting in the credit review provided the burden is not excessive for the organization and is highly unlikely to require government support.

DEBT SERVICING

Interest charges are also an important consideration in the analysis and are measured as a percentage of fiscal revenues in order to assess the affordability of outstanding debt. A look into the debt structure and the government's debt management strategy also helps assess the potential volatility of the servicing requirements. More particularly, analysts examine the maturity structure of the debt stock and its sensitivity to changes in inflation, interest and exchange rates. In keeping with the forward-looking nature of DBRS ratings, analysts will generally seek to develop a three- to five-year outlook for debt and debt servicing requirements.

LIQUIDITY

Due to their fairly predictable expenditure base and steady stream of revenue, provincial governments generally tend to minimize the amount of liquidity they carry on their balance sheet. Provincial governments also benefit from superior access to capital markets due to high investor receptivity, which considerably reduces refinancing risk and further reduces the need for back-up liquidity. Nonetheless, the presence of liquidity on a government balance sheet is viewed positively by DBRS. The primary sources of internal liquidity considered by DBRS include operating cash balances and investment portfolios, and are analyzed in relation to fiscal conditions, scheduled debt repayments and availability of external liquidity sources like bank facilities. Liquid assets will generally only be netted against debt if the funds are unrestricted and earmarked for debt retirement, or originate from pre-financing activities conducted for next year's purposes.

Key Debt and Liquidity Statistics

| | |
|---|---|
| Tax-supported debt/GDP | Pension plan liabilities/GDP |
| Debt structure: maturity, currency, interest rate | Annual borrowing needs/total debt |
| Debt servicing/revenue | Cash balances, reserve funds as % of spending |

Intergovernmental Relations

Relations between the government and its counterparts at both the federal and municipal levels are analyzed for their potential to alter the political landscape in the province and the fiscal position of the government. In particular, the provincial governments receive substantial funding from the federal government for key social programs within provincial jurisdiction such as health care and education, and through the equalization program, which enables the less prosperous provinces to offer public services comparable to those in other provinces at reasonably comparable levels of taxation. Therefore, a marked change in the funding envelope or in the allocation mechanism of one of the key transfer programs could have material implications for provincial governments. Conflicting tax or social policy objectives between levels of governments may also introduce challenges in fiscal management, as the provinces share their tax base and responsibility for certain programs with their senior counterpart. DBRS analysts pay particular attention to a government's dependence on federal funding, the structure of key federal transfer programs and the level of coordination in federal and provincial policy making.

Due to the influence of large cities over the provincial political process and since the responsibilities and powers of local governments are established by provincial legislation, DBRS looks at the relationship between the provincial government and its municipalities. Analysts primarily focus on the sustainability of the financial position of the largest cities in the province and on any existing tensions between the two levels of governments. Widespread financial difficulties at the municipal level could put pressure on the province to provide assistance or translate into a higher provincial debt burden, and DBRS includes municipal tax-supported debt in its calculation of provincial tax-supported debt due to the influence provinces exert over their municipalities.

Political Environment

Canada enjoys one of the most stable political environments in the world. Nevertheless, a closer look at the political landscape may provide insight into the balance of power within the government, the possibility of major shifts in government priorities and, ultimately, the fiscal prospects of a province. DBRS's review of the political environment focuses on the province's track record of political stability, the public approval of the governing party, the stage of the election cycle and the influence exerted by the official opposition party. Also an important consideration is whether the governing administration is in a majority or minority position, as it can significantly impair the responsiveness of the government and adversely affect its ability to introduce needed policy changes.



Appendix A – DBRS Adjustments to Reported Financial Figures

In certain circumstances, DBRS may adjust the financial results reported by provincial governments in order to allow for better inter-provincial comparisons, to incorporate all material tax-supported activities that are not part of the reporting entity, or to present fiscal results that are more reflective of the impact of government activities on indebtedness. The most frequent adjustments relate to the following areas:

(1) **Tax-supported debt:** Despite constantly improving provincial accounting rules, the level of consolidation continues to vary across provinces. In an effort to capture the full extent of a government's tax-supported financial liabilities, DBRS adds to a province's own tax-supported debt the debt of all material tax-supported entities, including school boards, hospitals, universities and provincial agencies conducting tax-supported activities. DBRS also includes municipal debt and unfunded pension liabilities, if any, as part of provincial tax-supported debt.

(2) **Capital expenditure treatment:** DBRS converts capital expenditures from an amortization basis to a "pay-as-you-go" basis to get fiscal results that are more reflective of the full extent of government spending and of external financing needs for a given year.

(3) **Non-recurring items:** Fiscal results sometimes include extraordinary items that introduce distortions in results and hinder year-over-year comparisons of results. These may include asset sales performed to boost revenues and balance budgets in challenging fiscal times, restructuring costs or write-off of tax receivables. DBRS attempts to remove all material non-recurring items from reported results in order to better understand the underlying fiscal position of a government.

(4) **Smoothing mechanisms:** Some governments use contributions to/from reserves or fiscal stabilization funds to manage revenues and smooth fiscal results. Such contributions to and from smoothing reserves are excluded from reported results by DBRS in order to better appreciate the volatility of fiscal results and present the true trend followed by fiscal results.

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