February 24, 2005

The 2005 Canadian Federal Budget

Economics

Andrew Pyle – (416) 863-7707
andrew_pyle@scotiacapital.com

The Price Of Appeasement

In the world outside of the United States, where exchange-rate appreciation is imposing a drag on economic growth, most industrialized countries continue to face an extremely challenging fiscal policy environment. Rather than being able to implement policy measures aimed at stabilizing or enhancing growth, most will simply be happy to restrain the growth in budgetary deficits. Canada stands as one of the few exceptions to the rule, yet for all the envy that has shone down on Finance Minister Goodale as he prepared for today's 2005 budget, the public focus was more on how difficult a job the Liberals would have in divvying up multi-billion dollar surpluses in a minority government situation. The last time a minority government ended on a budget vote, the Conservatives were in a relatively easy position – squaring off against the greater social spending agendas of the Liberals and NDP. Today, Mr. Goodale needed to placate similar social demands from the NDP and Bloc, while satisfying the debt-reduction and tax relief petitions from the Conservatives. Failure on either side would potentially see the budget voted down and an election called – sort of like having to punt on the fourth down with only a couple of yards to go. However, instead of this being a challenge, it looks like the Liberals decided to take the offensive route and run the ball, using a combination of spending and taxation measures that did as much as financially possible to placate the contrasting demands from both sides.

The more relevant question is whether the price of appeasement was too high? With spending measures representing roughly four-fifths of the budget's total initiatives, we would argue that the real cost of appeasement was an increase in Canada's nearer-term economic vulnerability. Indeed, the 12% increase in program spending slated for F2005 is the highest pace of growth in over two decades, and at 12% of nominal GDP, expenditures represent the largest share in eight years. After adding in the measures announced since last year's budget (as well as election promises), the new initiatives ($41.8 billion worth) bring the grand total to over $75 billion, covering health care, provincial transfers, and municipal support via the transfer of gasoline taxes. Regional development agencies across Canada will see an increase in funding to the tune of $800 million. On the social spending side, the federal government held out a helping hand to both ends of the age spectrum – kicking in $5 billion over five years for early learning and child care, while raising the amount of Guaranteed Income Supplement benefits for seniors by $2.7 billion over five years. Aboriginal communities receive almost $735 million over five years. Moving offshore, the government is elevating its international assistance bill by $3.4 billion, with another $600 million going to global peace initiatives and diplomatic initiatives. One of the items on the Conservative wish list was military spending, and here the feds delivered a $12.8 billion increase in funding over five years.

Tax initiatives were relatively modest compared to the expenditures; however, it is here where we find most of the "un-leaked" elements of the budget. In terms of households, the government followed through with an increase in the personal tax exemption limit to $10,000. The problem is that this is very much a back-end loaded measure, as F2006 and F2007 see only increases of $100, followed by a $400 lift in 2008 and then a final increase of $600 in 2009 to the $10,000 threshold. A further boost to disposable incomes is offered by an increase in the RRSP contribution limit to $22,000 by 2009 and, effective immediately, RRSPs will no longer have a foreign content cap. There may be criticism that the government chose to go from a 30% limit to 100% in one shot, even though this simply brings Canada in line with what most other foreign investors are able to do – structure a global portfolio closer to real-world country shares. There will likely be some negative fallout for Canadian equities relative to the United States, over and above direct macroeconomic comparisons.

For Reg AC Certification and important disclosures see Appendix A of this report.

For the corporate sector, the only real offering was a 2% decline in the corporate tax rate to 19%, but the full implementation doesn't kick in until F2011. The corporate surtax will be eliminated for years after 2007. While these are positive measures for firms, the problem is that they will not provide adequate insulation in the near term should Canada's corporate sector get hit by further currency appreciation and/or an erosion in U.S. economic activity. This will compound the risk facing fiscal policy handlers in Ottawa, since a further deterioration in overall Canadian economic performance will impact not only profits and corporate taxes, but the growth in personal tax revenues as well. When you're running annual surpluses of over $10 billion, that's fine. It gets tricky when you've cut all the meat off the bone. The usual reserve and prudency factors are still present in the government's balanced budget forecasts, which allows for a further cumulative debt reduction of $16 billion by F2010 to $483.5 billion (30.6% of GDP). That leaves Canada in an enviable position relative to its global peers, but the days of easy surpluses could be drawing to an end. By weighting this year's budget so heavily to the spending side, the risk of reaching that end sooner than later has increased

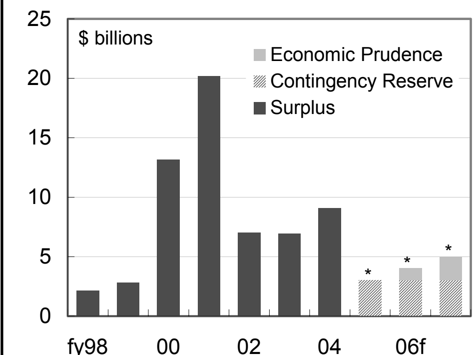
Fiscal Highlights

Mary Webb, (416) 866-4202

This year's strong revenues kickstart the broad initiatives: Total revenues are forecast to rise by 5.2% ($9.6 billion) in fiscal 2004-05 (F2005), boosted by the net proceeds of $2.6 billion from the sale of the government's remaining 18.6% share of Petro-Canada. Excluding this one-time gain, receipts are expected to climb 3.8%, with a 5.2% rise in tax revenues more than offsetting the downward trend in Employment Insurance receipts as premium rates edge lower. Solid job creation in 2004 and the boost to corporate profits from the upswing in international commodity prices helped to fill Ottawa's coffers. A further $1 billion saving on the debt service added to the planning surplus. With an underlying surplus approaching $14 billion this year, there is room to introduce a hefty $10.9 billion of new initiatives and still retain a $3 billion contingency reserve.

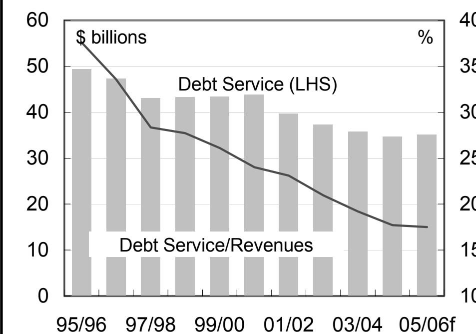
In addition, further solid revenue gains are forecast: Tax receipts are forecast to climb 4.4% next year and 5.2% in F2007, before tax reductions of $419 million and $814 million, respectively. Even without last year's one-time revenue boost, total revenues are still expected to advance next year by 2.3% ($4.6 billion) with a pickup to 4.8% growth ($9.7 billion) in F2007. From F2008 to F2010, revenues before the tax reductions roughly track expected real GDP growth of close to 5%.

Exhibit 1 – Reduced Fiscal Flexibility Going Forward



**A balanced budget (zero surplus is projected from FY05 to FY07).*
Source: Department of Finance; Scotia Economics.

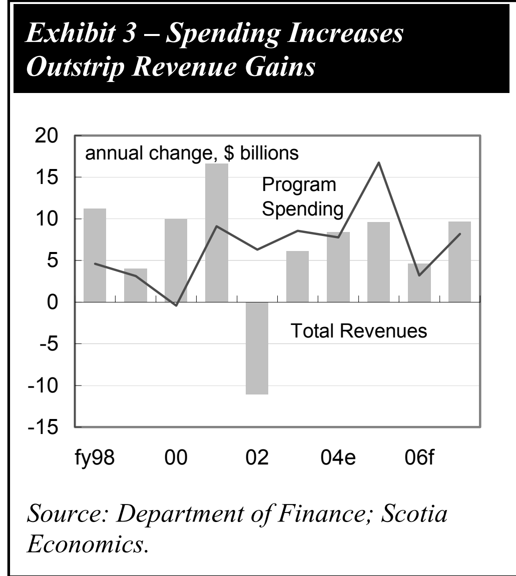
Exhibit 2– Federal Debt Burden Edges Lower



Source: Department of Finance; Scotia Economics.

Program spending surges this year: The planned 11.8% ($16.7 billion) rise in program expenditures for F2005 is the largest increase since F1983 and lifts outlays on a real per capita basis 7.3%. This builds on the upward trend in spending over the prior four years, when increases averaged just over 3% after inflation and population growth. The new spending initiatives represent a major injection to social services and address, to some extent, the longstanding issue of fiscal imbalance between Ottawa and the Provincial and Territorial governments. This year, new spending measures total $10.8 billion, with $5.8 billion allocated to health care after an accounting adjustment puts the entire $4.5 billion Wait Times Reduction Fund into F2005. The new Equalization framework adds $1.5 billion to transfers. With increased federal transfers and a major jump in resource receipts, the combined aggregate deficit forecast by the Provinces in their *Budgets* last spring has reversed to a sizeable surplus. Ottawa also provides close to $600 million of new regional development funding, which combined with targetted assistance for sectors totals $2.7 billion through F2010.

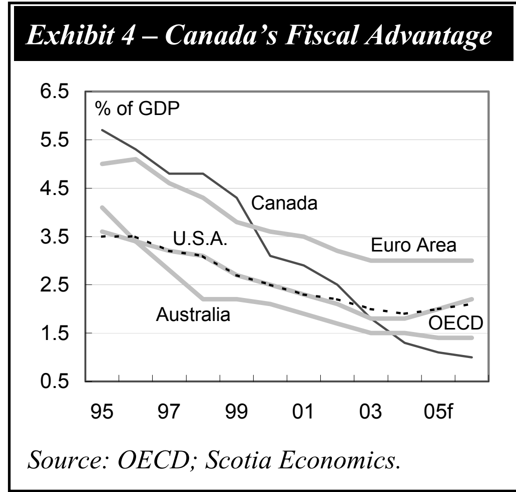
Exhibit 3 – Spending Increases Outstrip Revenue Gains



Source: Department of Finance; Scotia Economics.

And ratchets higher over the following five years: With numerous multi-year commitments, program spending is projected to rise a further 2% next year. For the five years to F2010, annual hikes in program spending average 4.2%. Program spending settles in at 11.9% of GDP, just below the levels of the late 1990s. Spending accounts for over four-fifths of the $75.7 billion of new initiatives from F2005 to F2010, while tax relief totals $14.2 billion. Key to affording these extensive new outlays is the $10.9 billion of savings for the five years to F2010 outlined by the Expenditure Review Committee. These savings will be allocated to the government's new priorities. The savings include streamlining and consolidating purchasing practices ($2.6 billion), improved property management ($1 billion) and departmental initiatives ($3.9 billion). The Employment Insurance program is highlighted for substantial new administrative efficiencies, whichwill be directed to improved benefits or lower premiums.

Exhibit 4 – Canada's Fiscal Advantage

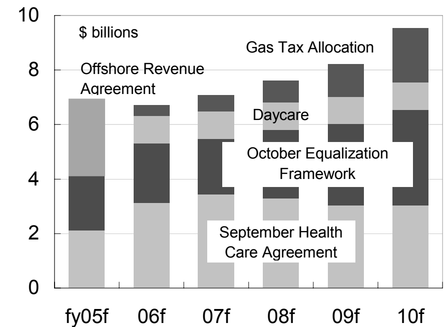


Source: OECD; Scotia Economics.

The risks to the outlook: To cover such a wide array of measures, Ottawa, for now, has reduced its surpluses available for planning to zero through 2010. Its commitments during the election in areas such as health care and Equalization have proven even more expensive than their platform estimates and a range of additional issues have demanded attention. The Liberals have accomplished a tough balancing act, offering personal and corporate tax reduction, but delaying $11.5 billion, or four-fifths, to F2009 and F2010. The $3 billion annual contingency reserve and the economic prudence that escalates from $1 billion in F2006 to $4 billion by F2010 offers a significant safety cushion.

Nevertheless, there are some risks. Intensifying headwinds for the Canadian economy could make the government's assumption of 3% growth this year and next optimistic (see following economic commentary). Scotia Economics looks for growth to be half a percentage point lower in both 2005 and 2006, but our estimate of nominal GDP increases is only significantly lower for next year. In 2006, however, Scotia Economics expects softer short- and long-term interest rates than the budget assumptions, providing some offset. Nevertheless, the government has committed to an ambitious agenda. It has shifted the risk in the Equalization program from the recipient Provinces to its own books, and built in annual escalators for the Canada Health Transfer and Equalization/Territorial financing of 6% and 3½%, respectively. Delivering on its promises would, therefore, be difficult in the event of an unexpected and extended slowdown in the Canadian economy. The government, however, has some fallbacks, including the possible sale of its share of the Hibernia offshore oil field.

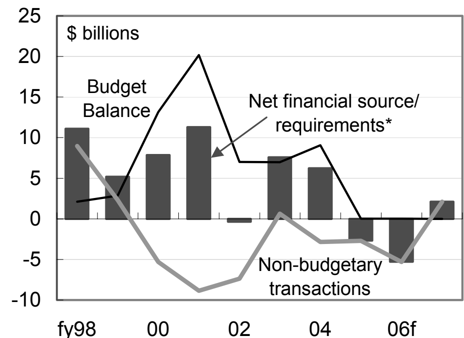
Exhibit 5 – Federal Transfer Increases to Provinces



Source: Department of Finance; Scotia Economics.

Slowing the debt reduction path: Ottawa has targetted a net debt-to-GDP ratio of 25% by 2014. Last year's allocation of the $9.1 billion surplus to debt retirement, which lowered the debt-to-GDP ratio to 41%, represents a valuable headstart given the government's projection of balanced books. Annual debt reduction of $3 billion would accomplish the 25% target by F2013, two years ahead of Ottawa's current schedule, so there is some room for setbacks. Nevertheless, with the approaching retirement of the leading edge of the baby boom generation, trimming debt service to about 12¢ of each revenue dollar by 2014, from an estimated 18¢ this year, is important. Canada has created an enviable fiscal advantage among its major trading partners. By 2006, the OECD estimates that Canadian governments' debt service will fall to 1% of GDP, one-third the level at the beginning of the decade and one-half the projected OECD average.

Exhibit 6 – Financial Requirements in the Near Term



Source: Department of Finance; Scotia Economics.

Corporate Initiatives: There is some attention to corporate competitiveness and encouraging saving and investment. For F2006 and F2007, corporate tax savings are limited to more generous CCA provisions and energy-efficiency incentives. But with the commitment to a lower general corporate income tax rate and reducing the surtax now made, these initiatives will hopefully be moved forward to enhance the policy balance over the next few years.

The Economics

Zubair Ladak, (416) 863-7463
Sarah Hughes (416) 866-4211

Consistent with the Liberal government's past and future commitment to sound fiscal management, Finance Minister Goodale delivered another balanced budget. The details of the budget call for GDP growth of 2.9% in 2005 and 3.1% in 2006, with growth averaging 2.9% from 2007 to 2009. On the financing front, 3-month bill rates are expected to track 2.7% and 3.5%, respectively, over the next two years, while corresponding 10-year interest rates are forecast at 4.6% and 5.1%. In both cases, estimates were revised lower from the government's November Economic and Fiscal Update. In terms of interest rates, we expect 3-month bill rates to hover around 2.5% this year, but ease back to the 2% mark in 2006; our 10-year interest rate forecast is also lower than the budget's projections, averaging 4.50% this year and 4.20% in 2006. Our more cautious take extends to the growth profile, with GDP forecast to advance a fairly tepid 2.5% this year and a similarly uninspiring 2.4% in 2006.

The government's interest rate outlook clearly reflects the benign inflation outlook and widespread agreement on steady short-term rates – at least in the near term. However, the government's growth assumptions appear a tad optimistic, especially if the Canadian dollar's ascent continues. Ironically, the budget document made detailed reference to the currency as a risk factor, yet also acknowledged that further U.S. dollar depreciation was needed in order to reduce the burgeoning U.S. current account deficit. With the global realignment of currencies expected to continue, the rising loonie will put continued pressure on the nation's currency-sensitive manufacturing and tourism sectors, with the drag being sufficient to offset the commodity-induced growth momentum witnessed in the western Provinces. Not surprisingly, we see countrywide output below potential through 2006. Having said that, contingency and prudence allocations will keep the government's balanced budget pledge intact through the forecast horizon. Nonetheless, if economic growth continues at its sub-par pace, there will be little, if any, wiggle room to embark on new spending initiatives.

Exhibit 7 – Economic and Interest Rate Assumptions

	Finance Assumptions*				Scotia Economics	
	2004e	2005f	2006f	2007-09f	2005f	2006f
Canada						
Real GDP	2.7	2.9	3.1	2.9	2.5	2.4
GDP Deflator	3.3	2.0	1.9	1.9	2.5	2.0
Nominal GDP	6.1	4.9	5.0	4.8	5.0	4.4
Employment	1.7	1.4	1.5	1.4	1.3	1.0
3-mos. T-bills (%)	2.2	2.7	3.5	4.6	2.4	2.0
10-yr. Bonds (%)	4.6	4.6	5.1	5.6	4.5	4.2
U.S. Real GDP	4.4	3.6	3.4	n.a.	3.1	3.0

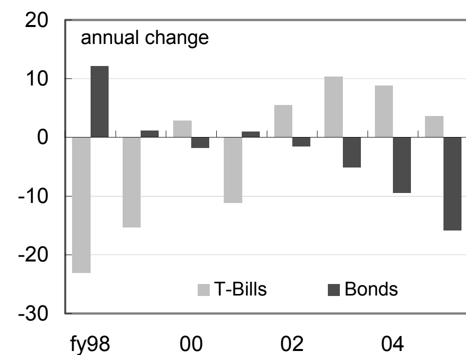
**Private sector average.*
Annual percent changes unless otherwise noted.
Source: Federal Budget 2005; Scotia Economics.

Market Implications

Mark Chandler, (416) 945-5252

Almost certainly, there will be a knee-jerk response in currency markets to the elimination of the 30% foreign property limit. It is possible that the Canadian dollar would trade lower on this news in anticipation of large capital outflows. However, we would caution against this reaction for a couple reasons: first, in the majority of countries with no such restrictions, the proportion of foreign holdings are not always much larger; second, in aggregate, Canadians have not already used all their available room for foreign holdings; third, while past increases in the foreign content limit (to 20% and, subsequently 25%) may have led to equity outflows, these came in very different circumstances (i.e., when money was strongly concentrated in IT and tech investments); and, fourth, derivatives have afforded more sophisticated investors many ways of avoiding the current limits. The response in fixed-income markets will depend to a large degree on how the Canadian dollar moves. A weaker currency would yield some increase in short-term interest rates (markets are currently expecting rates to increase 50 basis points or more by year's end, an assessment we do not agree with. We expect the Bank of Canada to remain on hold at least until Q4). However, this budget represents only modestly stimulative fiscal policy, despite the spending increases in the current year (the budget surplus of $9.1 billion last year will likely be cut to $3 billion when all is said and done this year). Financial requirements are projected at $2.7 billion in the current year and $5.3 billion in F2006 – suggesting no significant supply pressures in bond markets (the Debt Management Strategy is due next month). For the corporate sector, the budget may prove a mildly pleasant surprise. Not only will tax rates fall (albeit a few years hence), but there are also accelerated depreciation rates enacted for a wide range of equipment (pipeline, telecommunication, and electrical generation). The amount of the accelerated capital cost allowance is $245 million over the next five years.

Exhibit 8 – Debt Management



Source: Department of Finance; Scotia Economics.

Industry Highlights

Patricia Mohr, (416) 866-4210
Carlos Gomes, (416) 866-4735
Sebastian Gerlich, (416) 933-2645

To boost productivity and maintain a healthy economy, the Minister of Finance introduced a number of measures aimed at maintaining a competitive corporate tax system, creating a more efficient regulatory environment, promoting innovation, and creating an inclusive workforce. Initiatives intended to meet Canada's commitments under the Kyoto Protocol on "climate change," a "new deal for cities," and a commitment to develop an economic strategy for Northern Canada (related to the Mackenzie Valley Pipeline) were also announced.

A Competitive Corporate Tax System

Ottawa proposes to eliminate the corporate surtax by 2008. The corporate income tax rate will also be cut from the current 21% to 20.5% in 2008, 20% in 2009 and 19% in 2010. The elimination of the corporate surtax will cost Ottawa $3 billion by 2010 and the reduced corporate tax rate $1.36 billion.

The reduction in the corporate income tax rate by decade-end will leave Canada's manufacturing sector with a 4.5 percentage point advantage over the United States. Without these measures, Canada's advantage would have dwindled to only 1.4 percentage points. While moving in the right direction, these tax reductions are only phased in slowly, reducing their effectiveness in offsetting a stronger Canadian dollar and competitive international conditions for manufacturers.

To better align capital cost allowances (CCA) with the useful life of assets, the government proposes to increase CCA rates as follows: the rate for electric power motors will increase from 8% to 15%; for electricity transmission & distribution from 4% to 8%; for oil & gas pipelines from 4% to 8% (and to 15% for compression & pumping equipment) and for cables used in telecommunications from 5% to 12%. These changes are expected to reduce federal revenues by $245 million through 2010.

Kyoto Protocol on Climate Change

Canada's commitment under the United Nations Kyoto Protocol, which came into effect on February 16, 2005, is an ambitious one (especially for an energy-intensive economy). The target is to lower greenhouse gas emissions (mostly carbon dioxide, methane, and nitrous oxide) to 6% below 1990 levels on average through the first commitment period (2008-2012) – a reduction of 240 MT (30%) from the projected "business as usual" emissions level in 2010.

The budget provides additional funding of $3 billion to promote wind power, increased retrofitting of homes and "green" infrastructure spending in cities. This includes a $1 billion Clean Fund, which will effectively fund greenhouse gas emission projects and contribute to the development of an emissions trading system. The capital cost allowance rate will also be increased from 30% to 50% for efficient and renewable energy generation equipment.

The government's approach in the budget is one of encouraging lower emissions through incentives and voluntary measures, rather than mandatory regulations. However, Ottawa is pursuing agreements with large industrial emitters such as oil & gas and power producers, which may set mandatory targets for emission reductions (possibly 12% from what emissions would have been in 2010). The government is also negotiating with the auto manufacturers to achieve a 25% improvement in vehicle fuel efficiency (or its equivalent in greenhouse gas reductions) by 2010.

It is important to note that neither of Canada's NAFTA partners (the United States and Mexico) has ratified the Kyoto Protocol, potentially posing a competitive risk for Canada. Measures reducing energy use and lowering operating costs will mitigate some of this risk.

Financial Services Industry

Ottawa is working towards establishing a national securities regulator and intends to meet with provincial and territorial governments on this issue.

The government plans to increase CDIC deposit insurance coverage from $60,000 to $100,000.

A consultation paper in the budget will kick off discussion, as Canada updates its financial sector legistation by October 2006. To improve regulatory efficiency, Ottawa will work to reduce duplication between CDIC and OSFI.

New Deal for Cities

Ottawa will share $5 billion of the federal gasoline tax with cities over the next five years and an additional $4 billion with other communities, including rural municipalities.

Telecommunications Review

Ottawa intends to appoint a panel of eminent Canadians to review Canada's telecommunications policy and regulatory framework. This reflects the need to update policy in view of converging technologies and markets for traditional telephone, wireless and cable services, and the introduction of Internet Protocol (VoIP) telephone service.

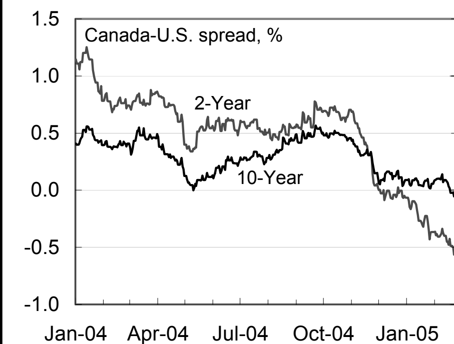
Debt Management/Financial Requirements

Mary Webb, (416) 866-4202

Financing Requirements

Non-budgetary transactions result in financing requirements for both F2005 and F2006: With projected balanced books, Ottawa's financing requirements this year and next reflect negative non-budgetary transactions totalling $2.7 billion and $5.3 billion. The requirement largely reflects current asset transfers of $4.8 billion this year and $2.7 billion in F2006 from the Canada Pension Plan (CPP) operating balance to the CPP Investment Board. Borrowing for capital assets adds almost $1 billion, and this amount increases from F2008 to F2010 for defence-related purchases. Financing for loans under the Canada Student Loans Program also hikes the borrowing required. For now, financial sources of just over $2 billion are projected for F2007 and F2008.

Exhibit 9 – Relative Value



Source: Bloomberg; Scotia Economics.

Ottawa's borrowing will continue to favour short-term financing: Ottawa has committed to reducing its ratio of fixed-rate obligations from two-thirds to 60%, limiting its longer-term issuance even with the positive financing requirements anticipated. A debt management strategy for F2006 is expected in March. The government is expected to remain committed to maintaining market liquidity in the key benchmark issues, using its bond buyback program, which is expected to top $10 billion this year.

The debt service is expected to fall by roughly $1 billion this year to $34.7 billion, reflecting last year's hefty debt repayment and historically low interest rates. For F2006, Ottawa's estimated $400 million increase in the debt service may prove high, even with the projected financing requirement, if the Bank of Canada remains largely on hold for the next two years. Looking out to F2008, Ottawa expects the debt service to climb back over $36 billion, but the projected revenue growth will lower the ratio of interest costs to receipts from 17.7% this year to an estimated 16.5%.

Exhibit 10 – Ottawa's Fiscal Plan (fiscal years, $B)

	Actual	Forecast		
	03/04	04/05	05/06	06/07
Personal Income Tax	84.9	89.6	94.3	100.5
Corporate Income Tax	27.4	28.4	29.2	29.3
GST & Excise Taxes	41.4	43.4	44.9	47.0
Employment Insurance Premiums	17.5	17.1	17.2	17.6
Other Revenue	15.0	17.3	14.9	15.7
Total Revenue	**186.2**	**195.8**	**200.4**	**210.1**
Transfers: Persons	42.0	43.2	44.9	46.8
Transfers: Other Cdn Gov'ts	29.4	39.1	37.5	40.0
Other Program Spending	70.0	75.8	79.0	82.7
Total Program Spending	**141.4**	**158.1**	**161.3**	**169.5**
Operating Balance	**44.9**	**37.7**	**39.1**	**40.6**
Debt Service	35.8	34.7	35.1	35.6
Contingency Reserve	0.0	3.0	3.0	3.0
Economic Prudence	0.0	0.0	1.0	2.0
Budget/Planning Surplus	**9.1**	**0.0**	**0.0**	**0.0**
Non-Budgetary Transactions	-2.8	-2.7	-5.3	2.1
Financial Source/Requirements	**6.2**	**-2.7**	**-5.3**	**2.1**
Net Federal Debt*	**501.5**	**498.5**	**495.5**	**492.5**
Annual Per Cent Change				
Personal Income Tax	3.9	5.5	5.2	6.6
Corporate Income Tax	23.4	3.6	2.6	0.5
GST & Excise Taxes	0.0	4.9	3.4	4.6
Total Revenues	**4.7**	**5.2**	**2.3**	**4.8**
Transfers: Persons	4.4	3.1	3.7	4.3
Transfers: Other Cdn Gov'ts	-4.1	32.9	-4.0	6.6
Program Spending	**5.8**	**11.8**	**2.0**	**5.1**
Real Program Spending/Capita	1.6	7.3	-1.0	2.1
Debt Service	-4.0	-3.0	1.2	1.4
Memo Items				
Total Revenues/GDP	15.3	15.1	14.8	14.8
Program Spending/GDP	11.6	12.2	11.9	11.9
Debt Service/Revenues	19.2	17.7	17.5	16.9
Net Federal Debt/GDP				
Apply Contingency Reserve to Debt	41.1	38.6	36.5	34.7
No Debt Reduction	41.1	38.8	36.9	35.4

Source: Federal Budget 2005; Scotia Economics.

Portfolio Strategy

Vincent Delisle, CFA– (514) 287-3628
vincent_delisle@scotiacapital.com

Hugo Ste-Marie, CFA – (514) 287-4992
hugo_ste-marie@scotiacapital.com

Yesterday's release of the 2005 federal budget was light on surprises and the spotlight remained on Canada's fiscal success relative to other industrialized nations. Among measures that we feel could impact Canadian financial markets, we note the continuing pursuit of balanced budgets and debt reduction, mild tax relief for individuals and businesses, rising cap on RRSP contributions and the elimination of the 30% limit on foreign investments held in Canadian Registered Retirement Savings Plans and Registered Pension Plans.

We do not expect any significant short-term market implications for this 2005 budget as investors will remain focused on the trend in corporate profits, oil prices, and other U.S. concerns (currency, twin deficits). However, the continuation of sound fiscal policies is bound to be mid- to long-term positive as it enables inflation to stay under control and interest rates to remain low. Equity-wise, global trends have a much greater impact on the S&P/TSX.

Industrials – Transportation & Aerospace

James David, MBA – (514) 287-4535
james_david@scotiacapital.com

David Buma, CFA – (514) 287-4990
david_buma@scotiacapital.com

The only item of note with implications for the Canadian transportation sector is a very modest reduction in the air travellers' security charge (ATSC). Given the very small magnitude of the change, we believe it is unlikely to either stimulate travel or compel any of Canada's air carriers to re-evaluate entering ultra short-haul air transportation markets.

In this year's budget, the government is proposing a 15% reduction across the three categories of air travel: domestic, transborder, and other international. The level of the charge for air travel within Canada will be reduced to $10, from $12, for round-trip travel and to $5, from $6, for one-way travel. The level of the charge for transborder air travel will be reduced to $9, from $10. For other international air travel, the rate will be reduced to $17, from $20. The new rate regime is set out in the following table.

Exhibit 1 – ATSC Rate Structure

	Current Rate	New Rate
Domestic (one-way)	$6	$5
Domestic (round-trip)	$12	$10
Transborder	$10	$9
Other international	$20	$17

Note: The above amounts include GST or federal portion of HST where applicable.

Source: 2005 Federal Budget.

Gas & Electric Utilities

Sam Kanes, CA, CFA – (416) 863-7798
sam_kanes@scotiacapital.com

Turan Quettawala – (416) 863-7846
turan_quettawala@scotiacapital.com

There were a few announcements in the 2005 budget that should favorably impact capital spending at Canadian gas & electric utilities involved in pipeline projects, renewable assets, and co-generation equipment. The overall Kyoto spending of $5 billion over five years ($2 billion announced previously) was in line with the leaked estimates in the press this week. Full details are still lacking on several Kyoto fronts, such as how Canada will set up a CO_2 trading scheme, or what specifics will be behind international credit purchases from areas such as Chile (i.e., TransAlta's purchase) or Russia (as speculated in the press). Some initiatives impacting utilities are:

1. The Wind Power Production Incentive (WPPI) has been quadrupled to 4,000 MW, as expected.
2. A new Production Incentive was introduced that is expected to stimulate the installation of 1,500 MW of new renewable energy for projects commissioned between March 31, 2006, and April 1, 2011. The amount of the incentive remains unchanged at $10/MWh.
3. An unexpected increase in the Capital Cost Allowance (CCA) from 30% to 50% for certain high-efficiency co-generation equipment and all renewable energy generation equipment was proposed. The increased rate will apply to equipment acquired during the next seven years.
4. The 2005 budget also proposes a doubling of the CCA rate on liquid and gas transmission pipelines (including valves, monitoring devices, etc.) from 4% to 8%. This will help the economics of the frontier pipeline proposals in both gas and oil.
5. Combustion turbine CCA will increase from 8% to 15% for property acquired on or after February 23, 2005.
6. The government will provide $150 million over four years for costs related to regulatory approvals for the Mackenzie Valley Gas Project.

Overall, this is mildly positive for new Canadian investments in renewable power, pipelines, and co-generation turbine equipment. All Canadian energy utility stocks could benefit from the increased CCA on generation equipment, except Caribbean Utilities, and the increased CCA on pipelines is positive for utilities that invest in frontier pipelines. The lack of emission trading detail and prospective emission prices to be determined in Canada's yet to be specified open market will keep Canadian greenhouse gas emitters guessing for a while longer. In Europe's specified emission trading system for European Union Allowances, the cost per CO_2 tonne paid in Q1/05 to date is shown in Exhibit 1.

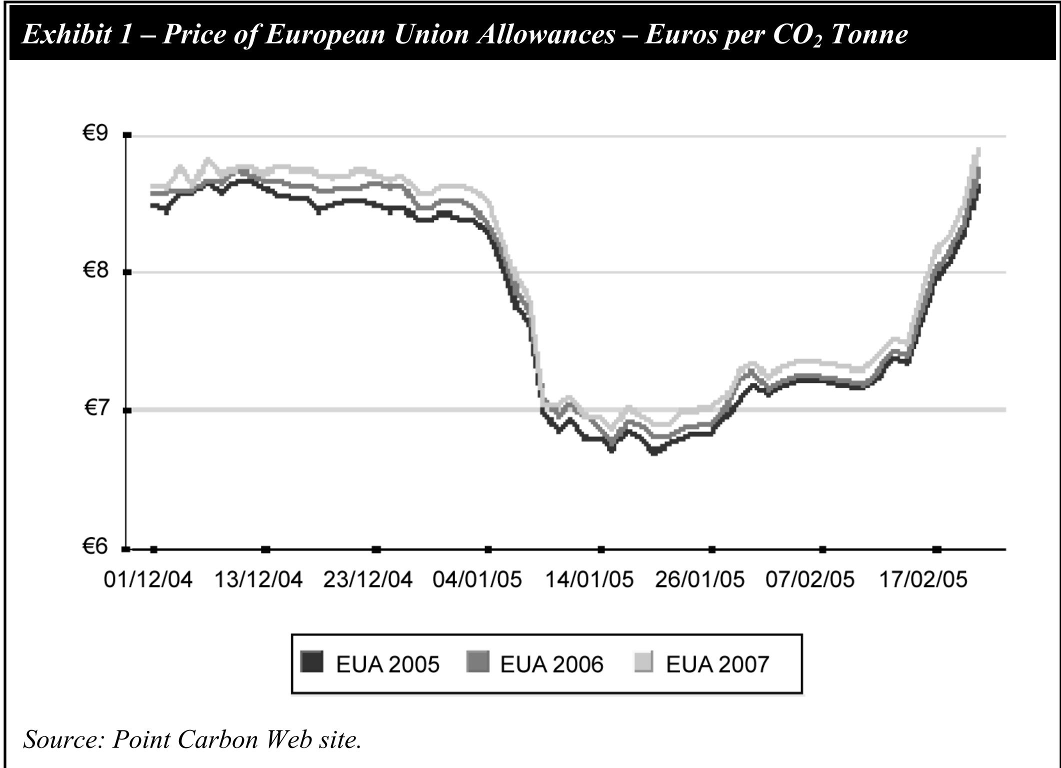


Exhibit 1 – Price of European Union Allowances – Euros per CO_2 Tonne

Source: Point Carbon Web site.

Income Trusts

Tony Courtright, MBA, CA – (416) 945-4536
Brian Ector, CFA – (403) 213-7332
Chris Blake – (416) 863-7067
Navdeep Malik, MBA – (416) 863-7499
Blair Wilson – (416) 863-7134

Implications of 2005 Budget for Business Trusts and Limited Partnerships

The Tax Measures annex indicates the Department of Finance will release a consultation paper shortly on the tax issues surrounding business income trusts and other flow-through entities (e.g., limited partnerships). Future initiatives, if any, will be taken following a consultation process with due consideration to the costs and benefits related to business trusts and other flow-through entities. In our opinion, this clearly indicates that the concern about potential erosion of corporate income tax revenue arising from increased investment by tax-deferred entities (e.g., registered pension plans) remains alive. The promise of an open and transparent consultative process with stakeholders on tax issues merely addresses the concerns expressed about last year's budget but does not imply closure has been reached.

We believe that the prospective inclusion of income trusts into the S&P/TSX Composite Index may impose urgency upon the consultative process. It also suggests that Royalty Trusts and REITs may be among the first income trusts to be seeded into the Composite Index under periodic rebalances.

The removal of foreign property restrictions (FPR) should expand the scope of potential investors in the five large publicly traded limited partnerships (Fort Chicago Energy Partners LP, TransCanada Power LP, Inter Pipeline Income Fund, TransAlta Power LP and Gaz Metro LP) that might otherwise be candidates for inclusion into the S&P/TSX Composite Index but for the FPR. We are unclear, however, whether separate restrictions limiting ownership of these partnerships to Canadian residents might still prevent their index inclusion.

Special Situations

Anthony Zicha – (514) 350-7748
anthony_zicha@scotiacapital.com

Vincent Perri, CA, CFA – (514) 287-3626
vincent_perri@scotiacapital.com

Marissa Caron – (514) 350-7756
marissa_caron@scotiacapital.com

Initiatives under the "New Deal for Cities and Communities" and "Ensuring a Sustainable Environment" sections of the 2005 budget may have implications for three companies under our coverage. Effectively, any incremental and/or accelerated funding of infrastructure and environmental projects bodes well for companies such as Stantec Inc. (STN-T), SNC-Lavalin Inc. (SNC-T), and Groupe Laperriere & Verreault Inc. (GLV.SV.A-T).

Specific initiatives announced in yesterday's budget that impact the companies cited above include:

1. **Sharing of gas tax revenues** worth $5 billion to support environmentally sustainable infrastructure. Such measures provide additional funding that may be directed towards infrastructure priorities such as roads, modern transit, and clean water.
2. Three hundred million dollars to enrich the **Green Municipal Funds**, which invest in innovative green municipal projects, including more efficient water and wastewater treatment facilities and the clean-up of brownfields.

Eligible investments will include capital expenditures for environmentally sustainable municipal infrastructure such as public transit, water and wastewater, community energy systems, and treatment of solid waste. Combined with previous budget initiatives, this represents a growing federal investment in municipalities.

Stantec has the most to gain from these announcements, given its long-standing relationships with municipalities, and with half of its revenues in North America originating from public contracts. Groupe Laperriere & Verreault Inc. could also benefit from support of municipal infrastructure projects related to water and wastewater treatment. To a lesser extent, SNC-Lavalin can benefit from added funding in infrastructure, but typically participates in large-scale projects.

While such initiatives are positive for the companies cited above, we do not expect any near-term material impact. Most of the initiatives are incremental and build on existing programs or projects, which we believe do not necessarily translate into new material contract awards. We maintain our 2-Sector Perform rating on Stantec and SNC-Lavalin and our 3-Sector Underperform rating on Groupe Laperriere & Verreault.

Financial & Estate Planning Group

Todd Herzog, CA – (416) 933-3258
todd_herzog@scotiacapital.com

Howard Kabot, CFP – (416) 945-4161
howard_kabot @scotiacapital.com

The 2005 federal budget contained a number of announcements related to personal and corporate income tax. Unless otherwise indicated, the following measures will apply effective with the 2005 tax year.

Changes to Personal Income Tax

The Basic Personal Amount

The basic personal tax amount will remain at $8,148 for 2005. It will increase by $100 in each of 2006 and 2007 and another $400 in 2008. By 2009, the amount will grow to at least $10,000.

The Basic Spouse, Common-Law or Wholly Dependent Relative Amount

For 2005, this amount is $6,919. This amount is due to increase by $85 in each of 2006 and 2007 and will increase by $340 in 2008. By 2009 the amount will grow to at least $8,500.

Retirement Savings

The money purchase pension plan annual contribution limit (currently $18,000) has increased as follows:

2006	2007	2008	2009	2010
$19,000	$20,000	$21,000	$22,000	indexed to average wage growth

The defined benefit pension plan maximum benefit per year of service amount (currently $2,000) is scheduled to increase as follows:

2006	2007	2008	2009	2010
$2,111	$2,222	$2,333	$2,444	indexed to average wage growth

The registered retirement savings plan annual contribution limit (currently $16,500) is also scheduled to increase as follows:

2006	2007	2008	2009	2010	2011
$18,000	$19,000	$20,000	$21,000	$22,000	indexed to average wage growth

The RRSP Foreign Property Rule

Effective January 1, 2005, the budget proposes to remove the limit on the amount of foreign property that can be maintained in pension funds and other tax-deferred retirement plans. The removal of this restriction also applies to Limited Partnerships.

Qualified RRSP Investments

For investments made on or after February 23, 2005, the budget proposes to add investment grade gold and silver bullion coins and bars, and certificates on such investments, to the list of qualified investments.

Registered Education Savings Plans

For an RESP beneficiary who qualifies for the disability tax credit, the budget proposes to:

- increase the maximum period for making RESP contributions from 21 to 25 years, and
- extend the termination date of the RESP from 25 to 30 years.

The Child Disability Benefit

First introduced in the 2003 budget, the budget proposes to increase the maximum annual CDB for the 2005/6 benefit year to $2,000 from $1,681.

Medical Expense Tax Credit for Caregivers

The budget proposes to increase the maximum amount of expenses that will be eligible for the medical expense tax credit that are incurred on behalf of a dependant relative from $5,000 to $10,000. As well, the list of eligible expenses for the METC has been expanded.

Adoption Expense Tax Credit

The budget proposes to introduce a 16% tax credit for eligible adoption expenses for the completed adoption of a child under the age of 18 years. The maximum expense that can be claimed in respect of a particular adoption will be $10,000.

Persons with Disabilities

The budget has proposed a number of changes related to the disabled. These include: (1) changes regarding the eligibility criteria for the disability tax credit; (2) an expansion of the list of qualified health practitioners who can certify impairments; (3) an expansion to the list of eligible expenses for the disability supports deduction; and (4) an increase to the maximum medical expense supplement from $571 to $750.

Changes to Corporate Income Tax

The Corporate Surtax

The budget proposes to eliminate the corporate surtax (currently at 4%) on January 1, 2008.

General Corporate Income Tax

The budget proposes to reduce the general corporate income tax rate, currently at 21%, as follows:

- to 20.5% effective January 1, 2008
- to 20% effective January 1, 2009
- to 19% effective January 1, 2010

Capital Cost Allowance

The budget proposes to adjust the CCA rates on the following asset classes: hydrocarbon transmission pipelines and related pumping and compression equipment, combustion turbines generating electricity, electricity transmission and distribution equipment, and cables used for telecommunications infrastructure.

Other Notable Proposals

Federally Regulated LIFs

For federal Life Income Funds (LIFs) the budget proposes to eliminate the rule that requires conversion of the LIF to an annuity at age 80.

Deposit Insurance Coverage

Effective immediately, the budget proposes to increase the CDIC amount to $100,000 from $60,000.

Appendix A – Important Disclosures

Company	Ticker	Disclosures*
Fort Chicago Energy Partners L.P.	FCE.UN	U
Gaz Metro Limited Partnership	GZM.UN	U
Groupe Laperriere & Verreault Inc.	GLV.SV.A	T, H6
Inter Pipeline Fund	IPL.UN	U
TransCanada Power, L.P.	TPL.UN	U

The following analysts certify that (1) the views expressed in this report in connection with securities or issuers they analyze accurately reflect their personal views and (2) no part of their compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed by them in this report: Tony Courtright, Anthony Zicha and Brian Ector.

The Research Analyst's compensation is based on various performance and market criteria and is charged as an expense to certain departments of Scotia Capital Inc., including investment banking.

Scotia Capital Inc. and/or its affiliates: expects to receive or intends to seek compensation for investment banking services from issuers covered in this report within the next three months; and has or seeks a business relationship with the issuers referred to herein which involves providing services, other than securities underwriting or advisory services, for which compensation is or may be received. These may include services relating to lending, cash management, foreign exchange, securities trading, derivatives, structured finance or precious metals.

For Scotia Capital Research Analyst standards and disclosure policies, please visit http://www.scotiacapital.com/disclosures.

* *Legend*

H6 The Portfolio Strategist/Associate, in his/her own account or in a related account, owns securities of this issuer.

T The Research Analyst/Associate has visited material operations of this issuer.

U Within the last 12 months, Scotia Capital Inc. has undertaken an underwriting liability with respect to equity securities of, or has provided advice for a fee with respect to, this issuer.

Definition of Scotia Capital Equity Research Ratings & Risk Rankings

We have a three-tiered rating system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe.

Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

Ratings

1-Sector Outperform
The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

2-Sector Perform
The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe by sector over the next 12 months.

3-Sector Underperform
The stock is expected to underperform the average total return of the analyst's coverage universe by sector over the next 12 months.

Other Ratings

Tender – Investors are guided to tender to the terms of the takeover offer.

Under Review – The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.

Risk Rankings

Low
Low financial and operational risk, high predictability of financial results, low stock volatility.

Medium
Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.

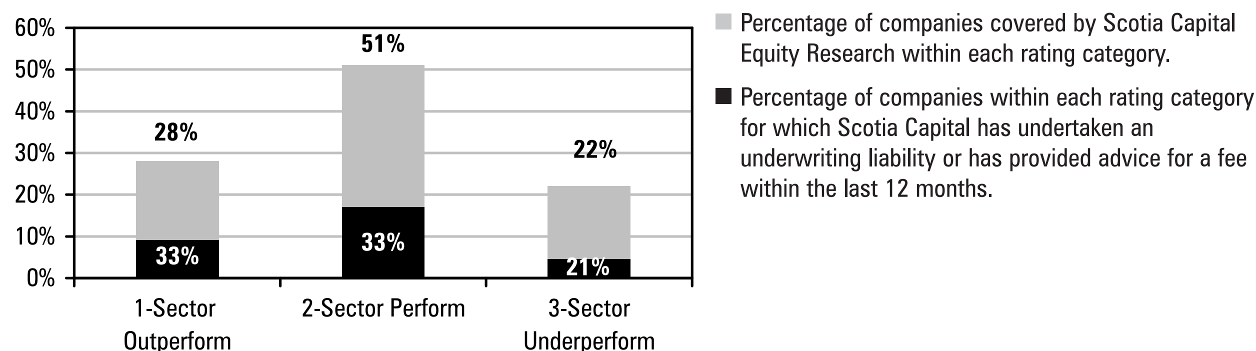
High
High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted
Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk-tolerant investors only.

Venture
Risk and return consistent with Venture Capital. For risk-tolerant investors only.

Scotia Capital Equity Research Ratings Distribution*

Distribution by Ratings and Equity and Equity-Related Financings*



**As at January 31, 2005.*
Source: Scotia Capital.

For the purposes of the ratings distribution disclosure the NASD requires members who use a ratings system with terms different than "buy," "hold/neutral" and "sell," to equate their own ratings into these categories. Our 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform ratings are based on the criteria above, but for this purpose could be equated to buy, neutral and sell ratings, respectively.