Figure 3 highlights the impact that fluctuations in oil revenue and Federal government transfers have on the Province's surplus or deficit. As the Figure shows, the significant increases in oil revenue ($317 million) and Government of Canada revenue ($132 million), were major factors in why the projected deficit of $492 million became an actual surplus of $199 million.

There is a sense of optimism about the potential prosperity for the Province and the resulting improvements to the Province's financial condition. The most significant area relates to the receipt of the $2 billion advance payment from the Government of Canada in July 2005 relating to the Atlantic Accord (2005), and the future revenues to be recognized resulting from this advance payment along with reductions in pension debt expenses. Another notable area is the continuing increase in oil revenues. These have had an immediate impact on the Province's financial position and are expected to have a significant impact on the Province's results of future operations. However, it has to be recognized that oil revenues are volatile and oil is a non-renewable resource with a limited life.

While it is encouraging that Government has made some progress regarding past annual deficits, prudent fiscal management and spending within its means has to remain a priority for Government if it is to make progress in improving the Province's financial position. As well, a debt reduction plan has to be developed and followed before the financial condition of the Province can be considered to have turned around.

3.4 Financial Indicators - Interpreting the Financial Information

An important role for my Office is to provide Members of the House of Assembly with information on the state of Government's finances. This information is necessary in order to have an informed debate about the issues that Government has to address. Issues include the ability of Government to fund programs and services, where the revenues will come from and the impact of surpluses, deficits and debt.

The Canadian Institute of Chartered Accountants (CICA), through the Public Sector Accounting Board (PSAB) is the professional body that approves standards for financial reporting and accounting in the public sector. It also issues research studies on public sector accounting matters.

CICA issued a Research Report in 1997 entitled Indicators of Government Financial Condition. That report identified financial indicators which it felt best describes the financial condition of a government. These indicators were categorized in terms of three elements of financial condition:

Sustainability - whether a government is living within its means;

Flexibility - whether a government can meet rising commitments by expanding its revenues or increasing its debt; and

Vulnerability - the extent to which a government relies on money from the Federal government or other outside sources to pay for existing provincial programs.

In this section, these indicators are discussed in the Newfoundland and Labrador context. Each indicator can and should be analyzed in detail, combined with other information and monitored over time.

Sustainability Indicators

Sustainability is the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy. Important sustainability indicators include:

- government's annual surplus or deficit; and
- government's net debt and a province's gross domestic product (GDP) in relation to net debt.

Each of these indicators provides useful insight into the sustainability of a government's revenue raising and spending practices.

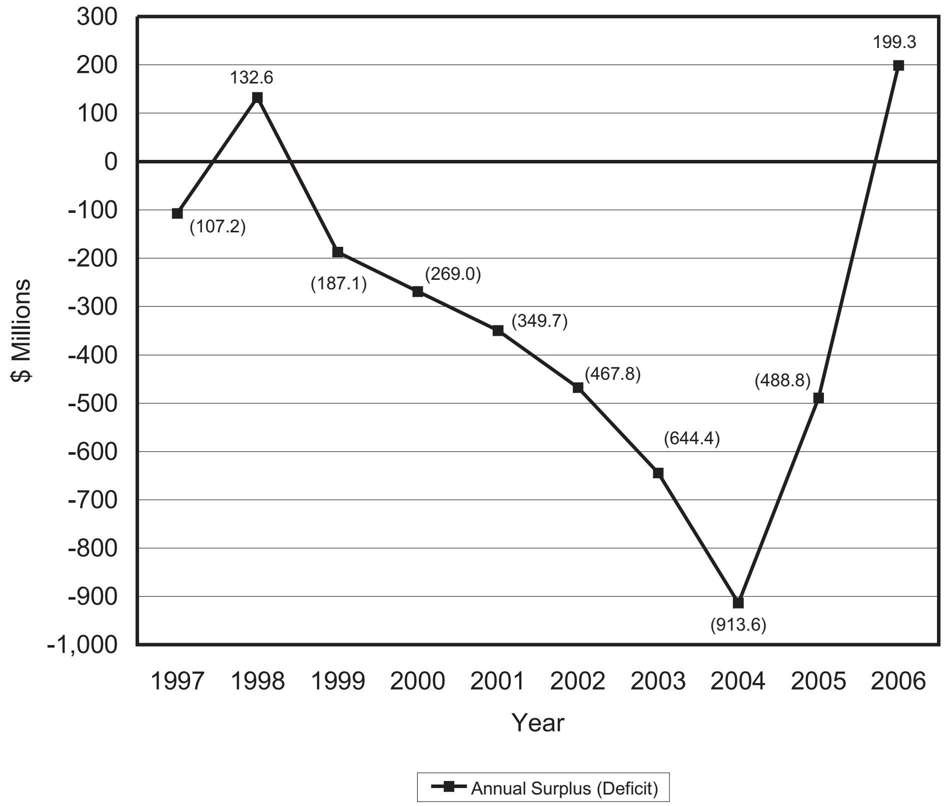
(a) Government's annual surplus or deficit

The annual surplus or deficit shows the extent to which a government spends less or more than it raises in revenues in one fiscal year. It is an indicator of whether a government is living within its means.

For the year ended 31 March 2006, the annual surplus reflected in the Province's consolidated summary financial statements was $199.3 million. Figure 4 provides details as to the annual surplus or deficit each year from 1997 to 2006.

Figure 4

Consolidated Summary Financial Statements
Annual Surplus (Deficit)
Years Ended 31 March
($ Millions)



As Figure 4 shows, with the exception of 1998 and 2006, Government has had an annual deficit each year. In 1998, there was a reported surplus of $132.6 million which resulted from a one-time payment of $348 million received from the Government of Canada related to the Labrador ferry service transfer. The Figure also shows that Government's annual deficit grew each year from 1998 to 2004, with a peak deficit of $913.6 million in 2004, the largest annual deficit recorded by the Province. Government also had an annual deficit in 2005; however, it had decreased from the record deficit in 2004, to $488.8 million. For 2006, Government had an annual surplus of $199.3 million, which was due in large part to an increase in oil revenue and an increase in Government of Canada revenue.

(b) Net debt and a province's gross domestic product (GDP) in relation to net debt

Users of a province's financial statements should look at long-term trends such as net debt to GDP and net debt as a percentage of GDP. Such trends are further indicators of whether a government is living within its means.

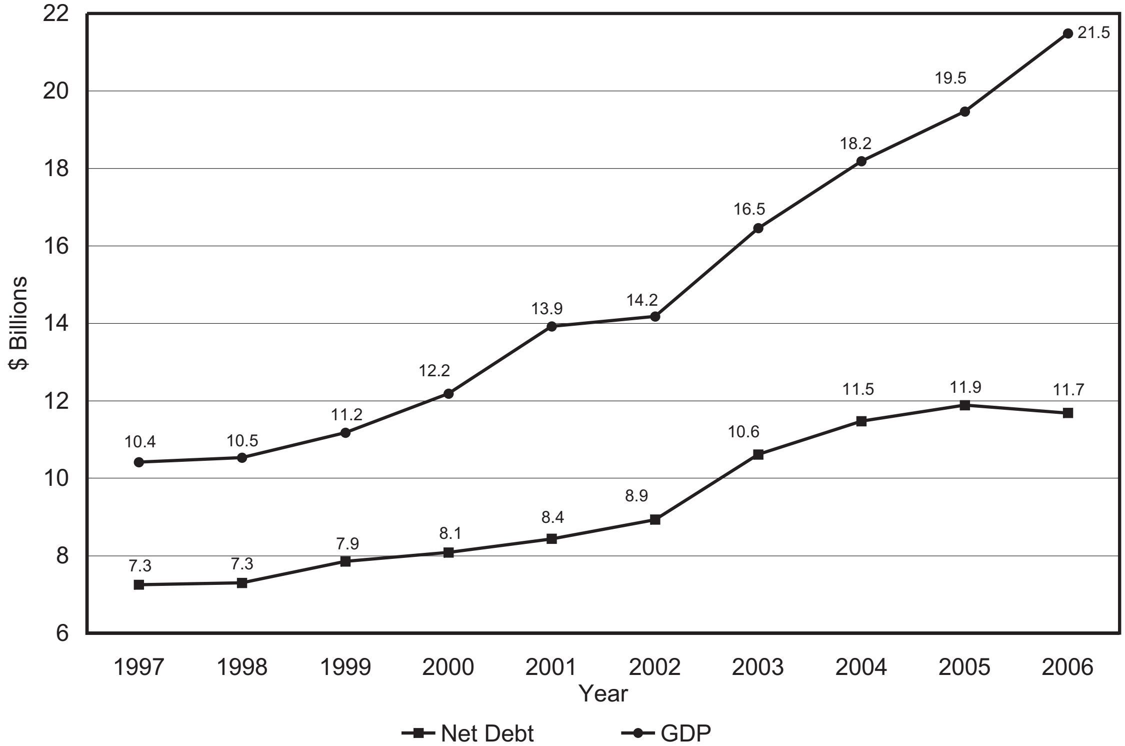
Net debt is the total of all liabilities reduced by financial assets (e.g. cash, temporary investments and receivables). It is the amount which the government of the day leaves for future governments to either repay or refinance. As at 31 March 2006, the net debt reflected in the Province's consolidated summary financial statements was $11.7 billion.

The Province's GDP is a measure of the total value of all goods and services produced in Newfoundland and Labrador in one year. It is the number most often used to indicate the size of a provincial economy. Government must manage its revenue raising and spending practices in the context of the economy of the Province.

Figure 5 provides details as to the net debt in relation to the GDP from 1997 to 2006. For purposes of this report, GDP for 2006 is reported at $21.5 billion, based on information obtained from the Provincial Department of Finance.

Figure 5

Consolidated Summary Financial Statements
Net Debt in Relation to GDP
Years Ended 31 March
($ Billions)

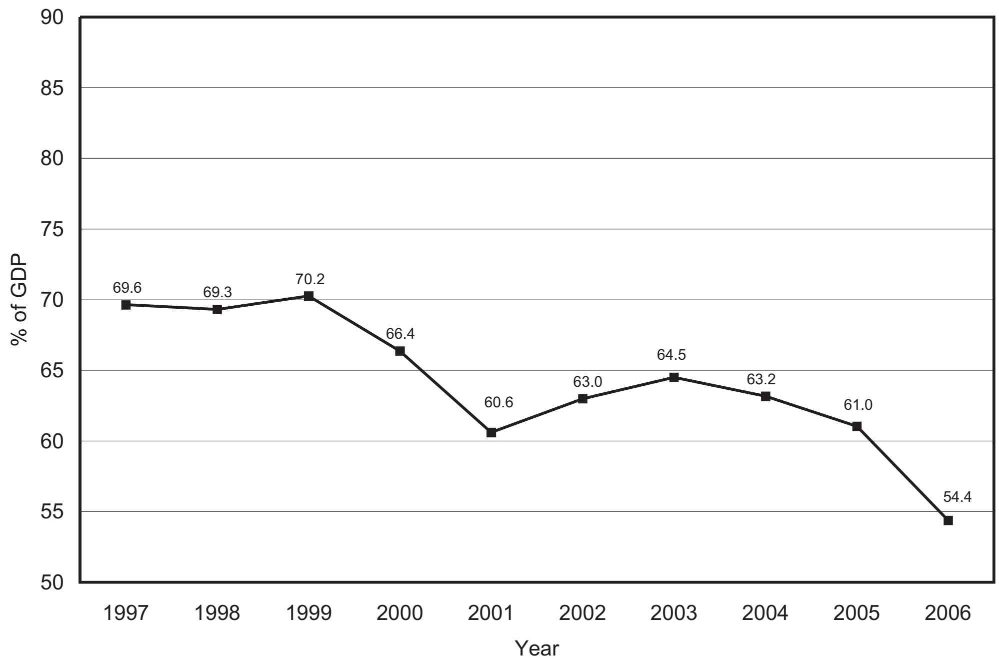


As Figure 5 shows, the GDP of Newfoundland and Labrador increased substantially from 1997 to 2006. The 2006 GDP of $21.5 billion is an increase of $11.1 billion (107%) from the 1997 GDP of $10.4 billion. Figure 5 also shows that, with the exception of 2006, the Province's net debt has increased each year since 1998.

The financial demands placed on the economy by Government's spending and revenue raising practices can be assessed for sustainability by comparing Government's net debt to the Province's GDP. The thinking behind this measure is that the larger the GDP the more debt Government can afford to carry. As Figure 5 shows, the Provincial GDP has been increasing and as a result, Figure 6 shows that the net debt as a percentage of GDP has decreased since 2003.

Figure 6

Consolidated Summary Financial Statements
Net Debt as a Percentage of GDP
Years Ended 31 March



As Figure 6 shows, the net debt of the Province as a percentage of GDP in 2006 was 54.4%, a significant decrease from the 70.2% in 1999. Although this is an improvement, the Province still has the highest net debt to GDP ratio of any province in Canada.

Flexibility Indicators

Flexibility is the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt. Important flexibility indicators include:

- interest costs as a percentage of total revenue; and
- own source revenues to GDP.

Together with a government's net debt and a province's GDP, these indicators provide insight into a government's flexibility in responding to rising commitments. For example, when a government has a large net debt and high interest costs, it has fewer resources to allocate to programs and services.

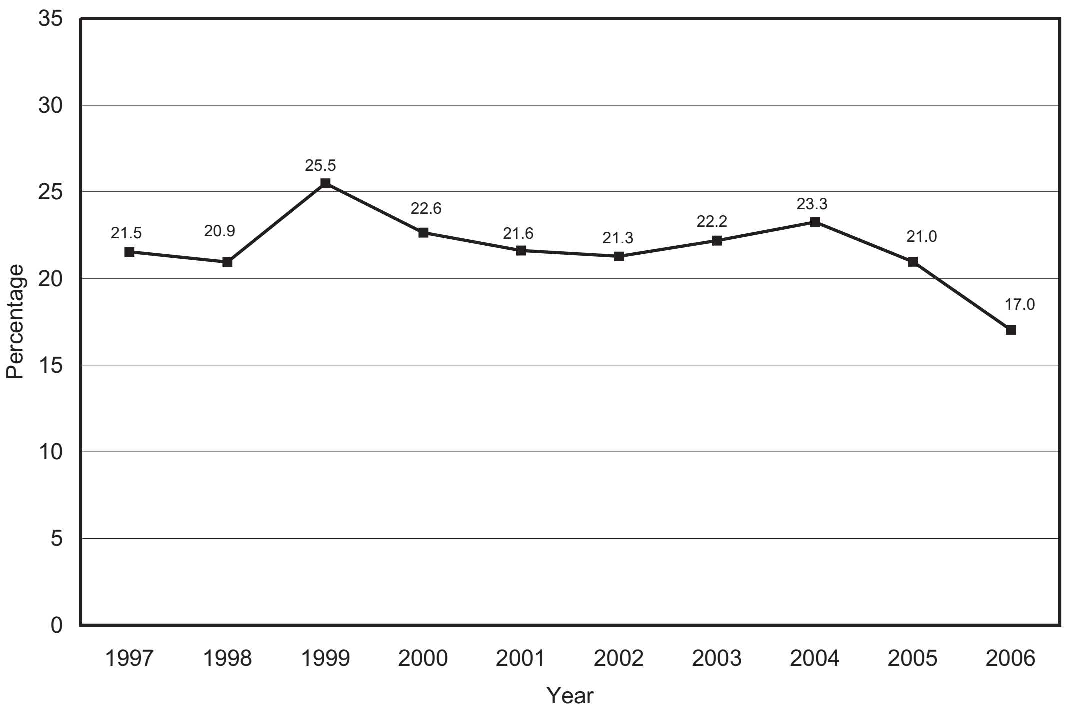
(c) Interest costs as a percentage of total revenue

Government incurs interest costs on its borrowings, as well as on its liabilities relating to retirement benefits. At 31 March 2006, Government's long-term debt net of sinking funds was \$6.5 billion, its unfunded pension liability was \$2.2 billion and its unfunded group health and life insurance retirement benefits liability was \$1.3 billion. In 2006, Government's interest costs (debt expenses) totalled \$947 million. The significance of debt expenses is that this money is not available to fund programs and services.

Interest costs as a percentage of total revenue, sometimes called the “interest bite”, is an important indicator of the state of a government's finances. This indicator shows the extent to which a government must use revenue to pay interest costs rather than to pay for programs and services. Figure 7 provides information on debt expenses as a percentage of total revenue from 1997 to 2006 and shows that the “interest bite” in 2006 was 17 cents per dollar of total revenue.

Figure 7

Consolidated Summary Financial Statements
Total Debt Expenses as a Percentage of Total Revenue
Years Ended 31 March



While Figure 7 indicates a significant decrease in debt expenses as a percentage of total revenue, these costs continue to be a substantial burden for Government. With 17 cents of every dollar going to debt expenses, Newfoundland and Labrador continues to have the highest debt expenses as a percentage of total revenue of any province in Canada.

Continued reductions in the interest bite would allow Government to use more of its revenues to pay for programs and services, and use less of its revenues to pay for debt expenses.

(d) Own source revenues to GDP

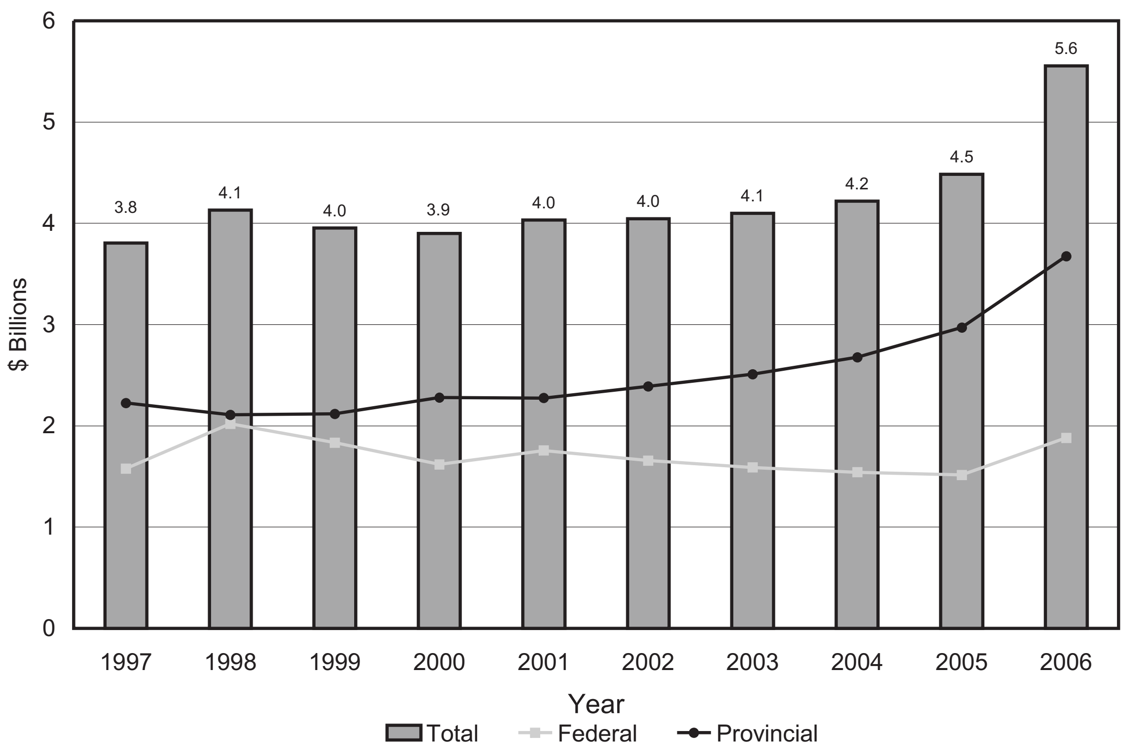
The Government of Newfoundland and Labrador raises revenue from two general sources. The first revenue source is from within the Province. This source is called "own source revenue". The second source of revenue is transfers from the Federal government.

Government's own source revenue to GDP reflects how much revenue Government can raise from the Provincial economy e.g. through taxes and fees. It shows the extent to which Government obtains its revenues from the Provincial economy as opposed to transfers from the Federal government, and the flexibility it has in increasing its financial resources through own source revenues if faced with decreases in Federal government revenue.

Figure 8 provides information on own source and Federal revenues from 1997 to 2006.

Figure 8

Consolidated Summary Financial Statements
Revenue by Source
Years Ended 31 March
($ Billions)



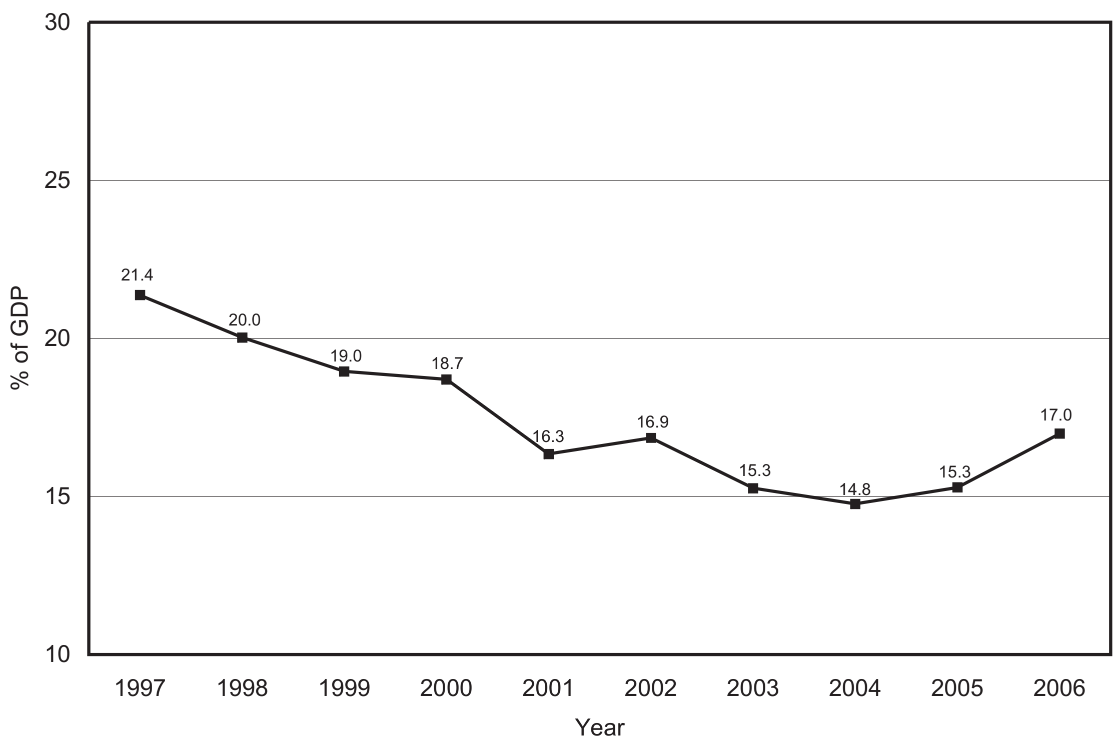
As Figure 8 shows, although a substantial portion of our total revenue continues to come from the Federal government, with the exception of 2006, Federal contributions have been on a decline since 2001. At the same time, Provincial revenues have increased. As a result, Federal revenues as a percentage of total revenues have declined from 44% in 2001 to 34% in 2006.

Another important factor to consider is the comparison of the change in a government's own source revenue to the size of the economy as indicated by the GDP.

Figure 9 provides information on this indicator from 1997 to 2006.

Figure 9

Consolidated Summary Financial Statements
Own Source Revenue as a Percentage of GDP
Years Ended 31 March



As Figure 9 shows, revenue raised from sources within the Province, as a percentage of GDP, declined from 21.4% in 1997 to 14.8% in 2004, with an increase to 17.0% in 2006. This means that since 2004 the Province has been taking more income out of the economy.

Vulnerability Indicators

Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence. This indicator measures the extent to which a government can manage its financial affairs without having to rely on others. Important vulnerability indicators include:

- Federal government revenues compared to own source revenues;
- foreign currency debt to total government debt; and
- oil revenues as a percentage of own source revenues.

(e) Federal government revenues compared to own source revenues

A significant portion of Government's revenue in this Province consists of transfers from the Federal government such as equalization, Health and Social Transfers and cost-shared programs.

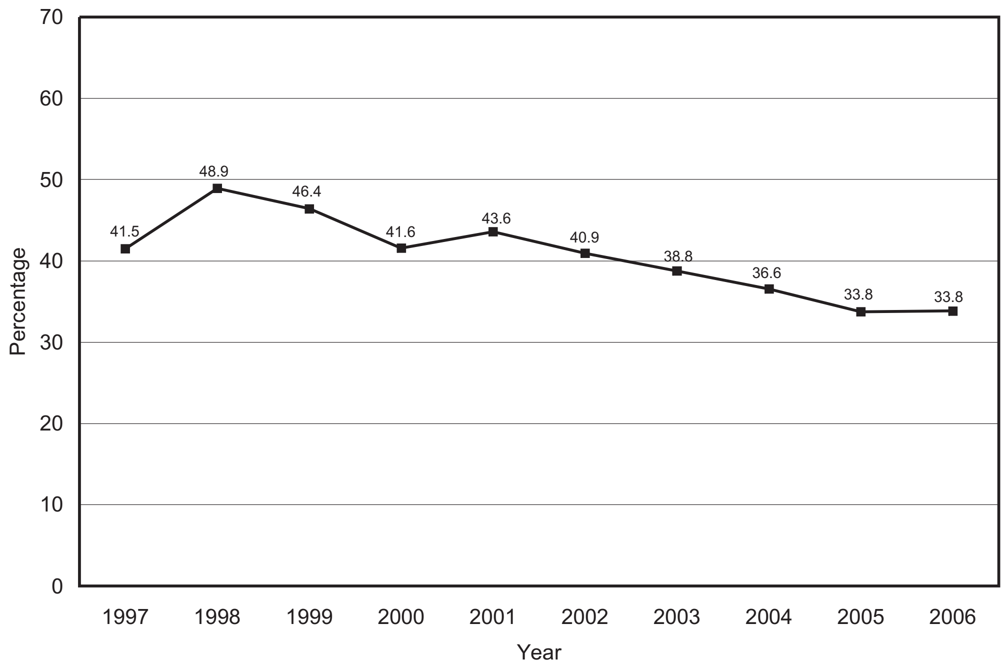
In the case of equalization, the Federal government calculates the amount of these transfers by comparing the ability of a province to raise revenues with a set standard for other provinces in Canada. As a result of this calculation, the annual amount of equalization transfers due to Newfoundland and Labrador is significantly affected by the performance of other provincial economies.

A comparison of Federal government revenues to own source revenues reflects how dependent Government is on transfers from the Federal government and how vulnerable Government is to changes in these transfers in its ability to finance its programs and services.

Figure 10 provides information on the percentage of Federal revenues compared to the Province's total revenues from 1997 to 2006.

Figure 10

Consolidated Summary Financial Statements
Federal Revenues as a Percentage of Total Revenues
Years Ended 31 March



As Figure 10 shows, Federal revenue as a percentage of total revenue has generally declined since 1998. This decline is due in large part to decreases in the Province's entitlement relating to Federal government equalization payments. These decreases in entitlement are impacted by factors including decreases in the Province's population.

As indicated in Figure 10, over the past ten years, Federal revenue as a percentage of total revenue ranged from a high of 48.9% in 1998, which resulted from a one time payment of $348 million related to the Labrador ferry service transfer, to a low of 33.8% for 2005 and 2006.

The lower the percentage of Federal revenues as a percentage of total revenues, the less potential impact, i.e. the vulnerability the Province has related to any change in these revenues.

(f) Foreign currency debt to total government debt

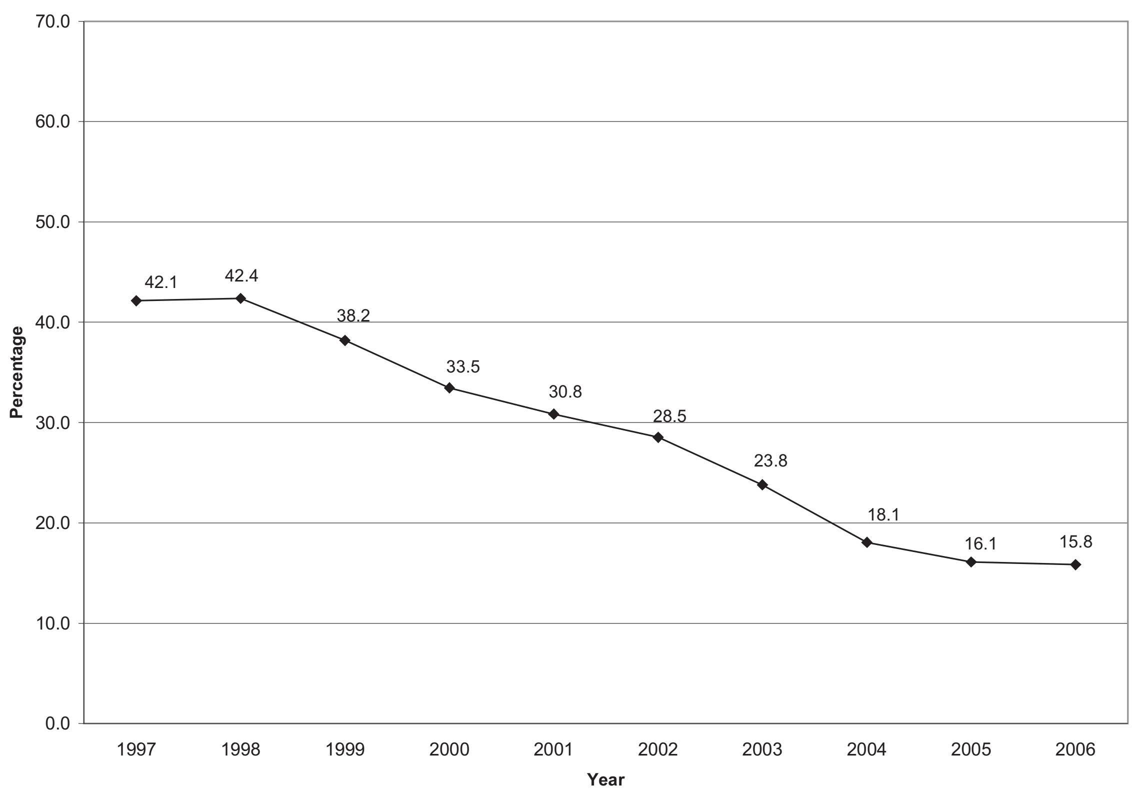
Of the $6.5 billion in total borrowings (net of sinking fund assets) as at 31 March 2006, $1.0 billion was foreign (U.S.) debt.

A comparison of a government's foreign debt to its total debt reflects the degree to which it is vulnerable to currency swings.

Figure 11 provides information on the Province's foreign currency debt as a percentage of its total debt from 1997 to 2006.

Figure 11

Consolidated Summary Financial Statements
Foreign Currency Debt as a Percentage of Total Debt (Net of Sinking Funds)
Years Ended 31 March



As Figure 11 indicates, over the last ten years, foreign currency debt as a percentage of total debt has been steadily decreasing from a high of 42.4% in 1998 to a low of 15.8% in 2006.

While Government is still vulnerable to currency swings, this risk has been minimized given the decline in the amount and percentage of foreign currency debt held. An increase/decrease of one cent in the foreign exchange rates at 31 March 2006 would have resulted in an increase/decrease in foreign borrowings of $11.5 million.

(g) Oil revenues as a percentage of own source revenues

There is a growing reliance by Government on oil revenue to fund its programs and services. This revenue source as a percentage of Provincial revenues has increased substantially in recent years. To illustrate, in 2004 oil revenue was $127 million (4.7% of own source revenue) while in 2006, oil revenue was $533 million (14.5% of own source revenue).

However, world oil prices are highly volatile and production levels relating to such non-renewable resources can vary significantly. Therefore, changes in these factors can result in significant differences between budget forecasts and actual. As a result, Government's financial position can be significantly impacted by factors outside its control. Figure 12 shows budget and actual oil revenue from 2004 to 2006 along with budget and revised forecasts for 2007.

Figure 12

Consolidated Summary Financial Statements
Oil Revenues: Budget, Actual and
Percentage of Own Source Revenues
Year Ended 31 March

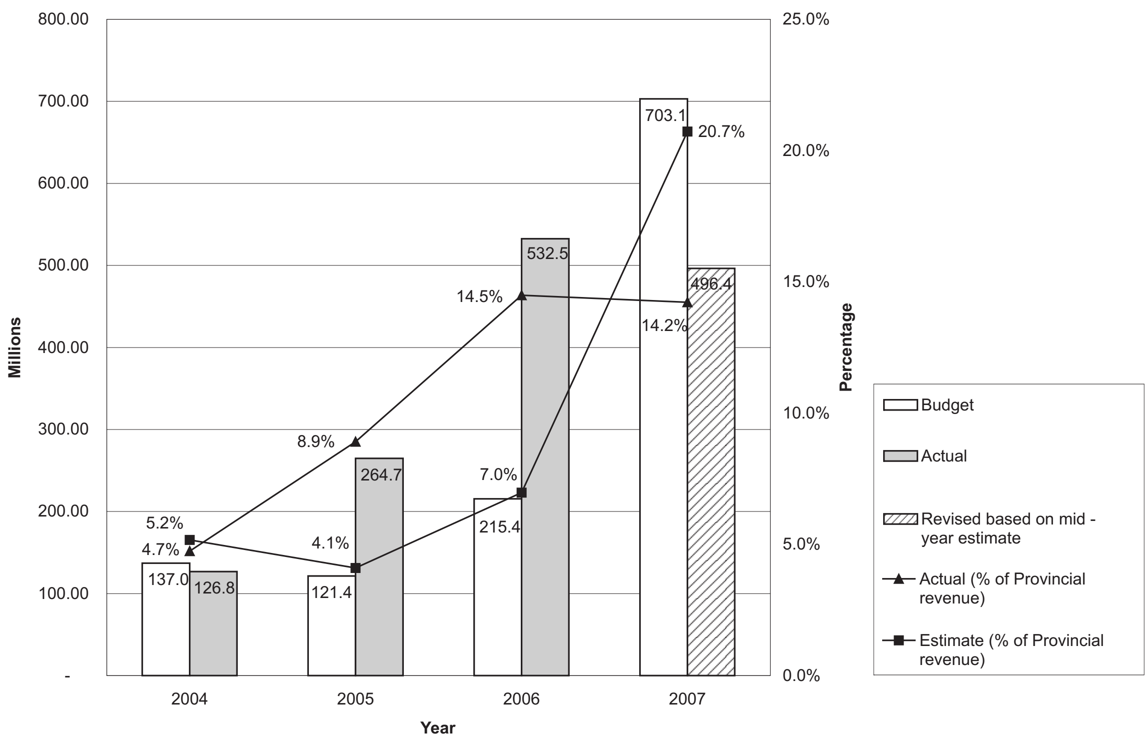


Figure 12 outlines differences between the budget forecasts and actual oil revenues from 2004 to 2006 (and forecasted for 2007) which, for the most part, are attributable to changes in oil prices and/or production levels. For example, in 2006 while oil revenue was budgeted at $215 million, actual oil revenue was $533 million, an increase of $318 million or 148%. This change could have been in either direction and highlights the vulnerability associated with this revenue source. Furthermore, although oil revenue was budgeted for 2007 at $703.1 million, in November 2006, Government reduced its oil revenue estimate by $206.7 million to $496.4 million in large part as a result of production issues.

Given its lack of control over oil prices and production levels, and its increasing dependence on this revenue source, Government has to carefully consider the degree to which it relies on this revenue source to fund its programs and services.