

# FORTISALBERTA INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

For the three and six months ended June 30, 2011

Dated July 13, 2011

*The following discussion and analysis of financial condition and results of operations of FortisAlberta Inc. (the "Corporation") should be read in conjunction with the Corporation's unaudited financial statements for the three and six months ended June 30, 2011 and the Management's Discussion and Analysis ("MD&A") and the audited financial statements for the year ended December 31, 2010. The financial information presented in this document has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP" or "Canadian GAAP") and is in Canadian dollars unless otherwise specified.*

### FORWARD-LOOKING STATEMENTS

*The Corporation includes forward-looking information in the MD&A within the meaning of applicable securities laws in Canada ("forward-looking information"). The purpose of the forward-looking information is to provide management's expectations regarding the Corporation's future growth, results of operations, performance, business prospects and opportunities and may not be appropriate for other purposes. All forward-looking information is given pursuant to the "safe harbour" provisions of applicable Canadian securities legislation. The words "anticipates", "believes", "budgets", "could", "estimates", "expects", "forecasts", "intends", "may", "might", "plans", "projects", "schedule", "should", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. The forward-looking information reflects management's current beliefs and is based on information currently available to the Corporation's management.*

*The forward-looking information in the MD&A includes, but is not limited to, statements regarding: the Corporation's expectation on remaining a regulated electric utility; the Corporation's expectations relating to the conduct, outcome and timing of regulatory hearings and other litigation matters; the Corporation's expectation to generate sufficient cash required to complete planned capital programs from a combination of long-term debt and short-term borrowings, internally generated funds and equity contributions; the Corporation's belief that it does not anticipate any difficulties in accessing the required capital on reasonable market terms; and the Corporation's forecast gross capital expenditures for 2011. The forecasts and projections that make up the forward-looking information are based on assumptions that include, but are not limited to: the Corporation's current business plans; the Corporation's understanding of the regulatory environment; the advice provided to the Corporation by its advisors; the receipt of applicable regulatory approvals and requested rate orders; no significant operational disruptions or environmental liability due to a catastrophic event or environmental upset caused by severe weather, other acts of nature or other major events; the Corporation's ability to maintain its electricity systems to ensure their continued performance; the commercial development of alternative sources of energy; favourable economic conditions; the level of interest rates; access to capital; maintenance of adequate insurance coverage; the ability to obtain licences and permits; retention of existing service areas; favourable labour relations; and sufficient human resources to deliver service and execute the capital program.*

*The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors that could cause results or events to differ from current expectations include, but are not limited to: legislative and regulatory developments that could affect costs, revenues and the speed and degree of competition entering the electricity distribution market; loss of service areas; costs associated with environmental compliance and liabilities; costs associated with labour disputes; adverse results from litigation; timing and extent of changes in prevailing interest rates; inflation levels; weather and general economic conditions in geographic areas where the Corporation operates; results of financing efforts; counterparty credit risk; and the impact of accounting policies issued by Canadian or provincial standard setters.*

*All forward-looking information in the MD&A is qualified in its entirety by the above cautionary statements and, except as required by law, the Corporation undertakes no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise after the date hereof.*

## THE CORPORATION

The Corporation is a regulated electricity distribution utility in the Province of Alberta. Its business is the ownership and operation of regulated electricity distribution facilities that distribute electricity generated by other market participants from high-voltage transmission substations to end-use customers. The Corporation does not own or operate generation or transmission assets and is not involved in the direct sale of electricity. The Corporation has limited exposure to exchange rate fluctuations on foreign currency transactions. It is intended that the Corporation remain a regulated electric utility for the foreseeable future, focusing on the delivery of safe, reliable and cost-effective electricity services to its customers in Alberta.

The Corporation operates a largely rural, approximately 113,000 kilometre, low-voltage distribution network in central and southern Alberta, which serves approximately 493,800 electricity customers comprised of residential, commercial, farm, oil and gas, and industrial consumers of electricity.

The Corporation is regulated by the Alberta Utilities Commission (the "AUC") pursuant to the *Alberta Utilities Commission Act* (the "AUC Act"). The AUC's jurisdiction, pursuant to the *Electric Utilities Act* (the "EUA"), the *Public Utilities Act*, the *Hydro and Electric Energy Act* and the *AUC Act*, includes the approval of distribution tariffs for regulated distribution utilities such as the Corporation including the rates and terms and conditions on which service is to be provided by those utilities.

The Corporation operates under cost-of-service regulation as prescribed by the AUC. Rate orders issued by the AUC establish the Corporation's revenue requirements, being those revenues required to recover approved costs associated with the distribution business, and provide a rate of return on a deemed capital structure applied to approved rate base assets. The Corporation applies for tariff revenue based on estimated costs-of-service. Once the tariff is approved, it is not adjusted as a result of actual costs-of-service being different from that which was estimated, other than for certain prescribed costs that are eligible for deferral treatment and are either collected or refunded in future rates. When the AUC issues decisions affecting the financial statements, the effects of the decision are recorded in the period in which the decision is received.

The Corporation is an indirect, wholly-owned subsidiary of Fortis Inc. ("Fortis"), a diversified, international electricity and gas distribution utility holding company having investments in distribution, transmission and generation utilities, real estate and hotel operations.

## REGULATORY MATTERS

### **2010/2011 Distribution Tariff Application ("DTA")**

On June 16, 2009, the Corporation filed a comprehensive Phase I and II application for 2010 and 2011 electric distribution service rates with the AUC. On July 6, 2010, the AUC issued Decision 2010-309 (the "Decision") on the Corporation's 2010 and 2011 Phase I DTA. The Corporation submitted a compliance filing for its 2010 and 2011 Phase I DTA on August 30, 2010 that incorporated Decision 2010-309. On December 6, 2010, the AUC issued Decision 2010-560 approving the 2011 distribution revenue requirement of \$368.3 million.

The regulated return on equity ("ROE") for 2011 was approved as 9.0 per cent on an interim basis in AUC Decision 2009-216 (the "Generic Cost of Capital Decision"). The AUC has initiated a proceeding to review the ROE and capital structure, which is discussed in further detail within the Outlook section.

On July 22, 2010, the AUC released Decision 2010-329 regarding the Corporation's Phase II DTA. The Corporation's Phase II rate design proposals were all effectively approved as filed. The Corporation submitted a Phase II compliance filing to obtain final approval of rates by customer class, to the AUC on September 10, 2010 based on the Phase I compliance filing with an effective date for new final rates and riders of January 1, 2011. On December 14, 2010, the Phase II compliance filing was approved in Decision 2010-576.

### 2012/2013 DTA

On March 31, 2011, the Corporation filed a Phase I application for 2012 and 2013 electric distribution service rates with the AUC. The Corporation is requesting approval of revenue requirements of \$410.3 million in 2012 and \$447.0 million in 2013, for rate increases of 8.2% and 6.9%, respectively. The rate increases are driven primarily by rate base growth associated with capital expenditures, which result in increased depreciation, interest and return on equity requirements. Net capital expenditures are forecast to be \$379.5 million and \$325.5 million in 2012 and 2013, respectively. The Corporation proposed a schedule for the DTA proceeding that would include a hearing in late October 2011 with a final decision expected in the first quarter of 2012.

### Review and Variance Application

Per Decision 2010-554, the AUC initiated a proceeding in respect of the Review and Variance Application to determine the prudence of capital expenditures related to the automated metering project above \$104.3 million. The Corporation received AUC Decision 2011-233 (the "Review and Variance Decision") on June 1, 2011. In the decision the AUC approved as requested the following:

- an additional \$21.4 million in capital expenditures relating to the automated metering project, the associated return and depreciation costs and carrying costs to be calculated using the weighted average cost of capital;
- the requested \$0.4 million for additional meter reading costs and associated carrying costs calculated in accordance with Rule 023;
- \$1.0 million in respect of System Settlement Code changes; and
- a deferral account restricted to costs arising from changes to AUC rules.

The Corporation has been directed to include the approved items above, in its omissions and updates filing for its 2012/2013 DTA. The impact of this decision on the financial statements is the recognition of \$2.5 million of electric rate revenue and an associated regulatory asset as at June 30, 2011.

### Central Alberta Rural Electrification Association ("CAREA") Application

On October 1, 2010, the CAREA filed an application with the AUC seeking a declaration that, effective January 1, 2012, CAREA be entitled to serve any new customer wishing to obtain electricity for use on property within their service area and that the Corporation be restricted to serving only those that are not being served by the CAREA. The Corporation has intervened in the proceeding.

## RESULTS OF OPERATIONS

### Highlights

| (\$ thousands)                          | Three Months Ended June 30 |        |                       | Six Months Ended June 30 |         |                       |
|---|----------------------------|--------|-----------------------|--------------------------|---------|-----------------------|
|   | 2011                       | 2010   | Increase / (Decrease) | 2011                     | 2010    | Increase / (Decrease) |
| Revenues                                | 103,715                    | 91,243 | 12,472                | 207,207                  | 179,099 | 28,108                |
| Operating costs                         | 35,533                     | 35,588 | (55)                  | 70,784                   | 71,073  | (289)                 |
| Depreciation                            | 30,016                     | 21,163 | 8,853                 | 59,622                   | 42,134  | 17,488                |
| Amortization                            | 3,423                      | 3,248  | 175                   | 6,740                    | 6,459   | 281                   |
| Income before interest and income taxes | 34,743                     | 31,244 | 3,499                 | 70,061                   | 59,433  | 10,628                |
| Interest expense                        | 15,317                     | 13,734 | 1,583                 | 28,921                   | 27,693  | 1,228                 |
| Income before income taxes              | 19,426                     | 17,510 | 1,916                 | 41,140                   | 31,740  | 9,400                 |
| Income tax expense (recovery)           | 357                        | 114    | 243                   | 873                      | (117)   | 990                   |
| Net income                              | 19,069                     | 17,396 | 1,673                 | 40,267                   | 31,857  | 8,410                 |

The following table outlines the significant increases/(decreases) in the Results of Operations for the three months ended June 30, 2011 as compared to June 30, 2010:

| Item                          | Increase/<br>(Decrease)<br>(\$ millions) | Explanation   |
|-------------------------------|--|---|
| Net Income                    | 1.7                                      | The increase in net income for the three months ended June 30, 2011 was mainly due to increases in revenue which were partially offset by increases in depreciation, amortization and interest expense.   |
| Revenues                      | 12.5                                     | <p>Electric rate revenue increased by a total of \$14.8. Of this increase, \$14.0 was attributable to distribution rate increases and customer growth. Also, there was a \$2.5 increase due to the impact of the Review and Variance Decision recorded in the second quarter of 2011. In addition, franchise fee revenue, A-1 rider revenue and various other revenue deferrals resulted in a net decrease of \$1.7.</p> <p>Other revenue decreased by a total of \$2.3. Net transmission revenue decreased by \$0.8 due to the Decision which resulted in the full deferral of transmission costs. The remaining decrease is due to a \$1.5 decrease in miscellaneous revenue.</p> |
| Depreciation and Amortization | 9.0                                      | The increase for the three months ended June 30, 2011 was due to higher overall depreciation and amortization rates as approved by the Decision, which were not reflected in 2010 until the third quarter. In addition, there was an increase in capital assets related to system growth, as well as upgrades and replacements of assets within the Corporation's service territory.  |
| Interest Expense              | 1.6                                      | Interest expense increased over the same period in 2010 due to an increase in debt levels from the issuance of long-term debt Series 10-1 that took place in October 2010 to finance increased capital assets and due to an increased average interest rate charged on the syndicated credit facility. These were partially offset by lower average drawings under the syndicated credit facility.  |

The following table outlines the significant increases/(decreases) in the Results of Operations for the six months ended June 30, 2011 as compared to June 30, 2010:

| Item                          | Increase/<br>(Decrease)<br>(\$ millions) | Explanation   |
|-------------------------------|--|---|
| Net Income                    | 8.4                                      | The increase in net income for the six months ended June 30, 2011 was mainly due to increases in revenue which were partially offset by increases in depreciation, amortization, interest expense and income taxes.   |
| Revenues                      | 28.1                                     | <p>Electric rate revenue increased by a total of \$28.7. Of this increase \$28.0 was attributable to distribution rate increases and customer growth. Also, there was a \$2.5 increase due to impact of the Review and Variance Decision recorded in 2011. In addition, franchise fee revenue, A-1 rider revenue and various other revenue deferrals resulted in a net decrease of \$1.8.</p> <p>Other revenue decreased by a total of \$0.6. Net transmission revenue decreased by \$0.8 due to the Decision which resulted in the full deferral of transmission costs. This is partially offset by an increase of \$0.2 in miscellaneous revenue.</p> |
| Depreciation and Amortization | 17.8                                     | The increase for the six months ended June 30, 2011 was due to higher overall depreciation and amortization rates as approved by the Decision, which were not reflected in 2010 until the third quarter. In addition, there was an increase in capital assets related to system growth, as well as upgrades and replacements of assets within the Corporation's service territory.  |

| Item                          | Increase/<br>(Decrease)<br>(\$ millions) | Explanation   |
|-------------------------------|--|---|
| Interest Expense              | 1.2                                      | Interest expense increased over the same period in 2010 due to an increase in debt levels from the issuance of long-term debt Series 10-1 that took place in October 2010 to finance increased capital assets and due to an increased average interest rate charged on the syndicated credit facility. The increases in interest expenses were partially offset by lower average drawings under the syndicated credit facility and higher allowance for funds used during construction ("AFUDC") in 2011. |
| Income Tax Expense (Recovery) | 1.0                                      | The increase in income tax expenses for the six months ended June 30, 2011 was primarily due to the change in net customer deferrals subject to future income taxes without an offsetting regulatory liability or asset, resulting in an increase in future income tax expense compared to the same period in 2010. In addition, the Corporation recorded a higher current income tax expense in 2011 related to the sale of assets.  |

### Current Economic Conditions

If the Corporation issues new long-term debt and the interest rates are higher than what is approved in its rates, the additional interest costs incurred on long-term debt will not be recovered from customers in rates during the period that is covered by the approved rates. When the Corporation files its next DTA, it will include the actual interest cost of the long-term debt in its applied for rates with the expectation that the approved distribution rates would allow for the recovery of the actual interest costs incurred in these future years. Other costs are similarly subject to change relative to what may be included in customer rates.

## SUMMARY OF QUARTERLY RESULTS

The following table sets forth certain quarterly information of the Corporation:

| (\$ thousands)     | Revenues | Net Income |
|--------------------|----------|------------|
| June 30, 2011      | 103,715  | 19,069     |
| March 31, 2011     | 103,492  | 21,198     |
| December 31, 2010  | 99,452   | 17,185     |
| September 30, 2010 | 109,911  | 19,180     |
| June 30, 2010      | 91,243   | 17,396     |
| March 31, 2010     | 87,856   | 14,461     |
| December 31, 2009  | 86,326   | 15,373     |
| September 30, 2009 | 84,015   | 15,458     |

There is no significant seasonality in the Corporation's operations.

Changes in revenues and net income from quarter to quarter are a result of many factors including regulatory decisions, energy deliveries, number of customer sites, growth of the distribution system, and changes in income tax expense based on fluctuations in future income tax expenses and recoveries which are due to changes in deferral account balances, availability of tax recoveries and levels of taxable income.

- Revenues increased by \$0.2 million for the three months ended June 30, 2011 compared to the three months ended March 31, 2011. Net income decreased for the three months ended June 30, 2011 compared to the three months ended March 31, 2011 by \$2.1 million primarily as a result of higher depreciation and amortization charges of \$0.5 million due to an increase in the depreciable base of assets during the current quarter compared to the prior quarter, as well as an increase in interest costs of \$1.7 million which was primarily due to higher drawings on the syndicated credit facility.

- Revenues increased by \$4.0 million for the three months ended March 31, 2011 compared to the three months ended December 31, 2010 primarily due to distribution rate increases and customer growth. Net income increased for the three months ended March 31, 2011 compared to the three months ended December 31, 2010 by \$4.0 million, due to the increase in revenues of \$4.0 million and a decrease in operating costs of \$2.3 million resulting from decreases of \$3.9 million in contracted manpower and \$0.6 million in other operating expenditures, partially offset by an increase of \$2.2 million in salaries and wages. This is partially offset by an increase of \$1.1 million in depreciation and amortization due to an increase in the depreciable base of assets, an increase of \$0.5 million of interest expense and an increase of \$0.7 million in income tax expense.
- Revenues decreased by \$10.5 million for the three months ended December 31, 2010 compared to the three months ended September 30, 2010 primarily as a result of AUC Decision 2010-309 being recorded in the third quarter of 2010. Net income decreased for the three months ended December 31, 2010 compared to the three months ended September 30, 2010 by \$2.0 million due to the decrease in revenues of \$10.5 million, an increase in operating costs of \$4.7 million, an increase in interest expense of \$0.3 million and a decrease in income tax recovery of \$0.1 million. This was partially offset by a net decrease in depreciation and amortization of \$13.6 million as a result of AUC Decision 2010-309 being recorded in the third quarter of 2010.
- Revenues increased by \$18.7 million for the three months ended September 30, 2010 compared to the three months ended June 30, 2010 primarily as a result of AUC Decision 2010-309. Net income increased for the three months ended September 30, 2010 compared to the three months ended June 30, 2010 by \$1.8 million due to the increase in revenues of \$18.7 million, a decrease in operating costs of \$2.7 million, a decrease in interest expense of \$1.0 million primarily due to the AFUDC and an increase in income tax recovery of \$0.4 million. This was partially offset by a net increase in depreciation and amortization of \$21.1 million as a result of AUC Decision 2010-309.
- Revenues increased by \$3.4 million for the three months ended June 30, 2010 compared to the three months ended March 31, 2010. Net income increased for the three months ended June 30, 2010 compared to the three months ended March 31, 2010 by \$2.9 million due to the increase in revenues of \$3.4 million and decreased interest expense of \$0.2 million due to the timing of drawings on the syndicated credit facility. This was partially offset by an increase in operating costs of \$0.1 million, an increase in depreciation and amortization of \$0.2 million primarily due to the increase in capital assets and a decreased tax recovery of \$0.4 million.
- Revenues increased by \$1.5 million for the three months ended March 31, 2010 compared to the three months ended December 31, 2009. Net income decreased for the three months ended March 31, 2010 compared to the three months ended December 31, 2009 by \$0.9 million, due to increases in operating costs of \$1.9 million, increased interest expense of \$0.5 million due to the issuance of the Series 09-2 debentures in October 2009 and a decreased tax recovery of \$0.4 million due to the reversal of deferrals in the first quarter of 2010. This was partially offset by a decrease in depreciation and amortization of \$0.4 million primarily due to the capitalization of depreciation on vehicles and tools used in the construction of other assets, which offset the effect of the increase in capital assets.
- Revenues decreased by \$1.8 million for the three months ended December 31, 2009 compared to the three months ended September 30, 2009, but were offset by the cumulative annual impact of \$4.1 million from the AUC Generic Cost of Capital Decision 2009-216, resulting in a net increase of \$2.3 million in revenues. Despite this increase in revenue, net income decreased for the three months ended December 31, 2009 compared to the three months ended September 30, 2009 by \$0.1 million, primarily as a result of an increase in interest expense of \$1.3 million, operating costs of \$0.7 million and depreciation and amortization of \$0.3 million, as well as a decrease in income tax recovery of \$0.1 million.

## FINANCIAL POSITION

The following table outlines the significant changes in the Balance Sheets as at June 30, 2011 as compared to December 31, 2010:

| Item   | Increase/<br>(Decrease)<br>(\$ millions) | Explanation  |
|--|--|--|
| <b>Assets:</b>   |  |  |
| Accounts Receivable  | 4.0                                      | The increase in accounts receivable was primarily due to increased customer contribution receivables of \$6.1. This increase was partially offset by a decrease in revenue accruals of \$1.9 and net decreases in other receivables of \$0.2.  |
| Regulatory Assets  | 4.8                                      | The increase in regulatory assets is largely due to an increase in the future income tax deferral of \$13.8, increase in deferred operating costs of \$5.1 and an increase of \$2.5 as a result of the Review and Variance Decision. Further, there was an increase in the Alberta Electric System Operator ("AESO") charges deferral of \$0.5 and increases in other regulatory assets of \$0.7. These increases were partially offset by a \$17.8 decrease in the 2010 distribution adjustment rider as it is being collected in 2011. |
| Property, Plant and Equipment<br>(net of accumulated<br>depreciation and the regulatory<br>tax basis adjustment) | 90.2                                     | Property, plant and equipment was comprised of net additions (adjusted for cost of removal and proceeds on retired assets) of \$137.1, less depreciation of \$59.6 (which includes the amount for future removal and site restoration costs recovered through depreciation and is net of regulatory tax basis adjustment amortization of \$1.7) and an increase in the provision for future removal and site restoration of \$12.7.  |
| <b>Liabilities:</b>  |  |  |
| Accounts Payable, Accrued and<br>Other Liabilities   | 6.2                                      | Increases in accounts payable, accrued and other liabilities are due to an increase in payables of \$7.2 for transmission connected projects. These increases are partially offset by an overall decrease in other accruals, payables and liabilities of \$1.0.  |
| Short-term Debt  | 36.3                                     | Short-term debt increased as the syndicated credit facility matures in May 2012; therefore, amounts previously classified as long-term have been reclassified. The amount reclassified was approximately \$39.9 which was partially offset by a decrease in the Corporation's negative cash balance of \$3.6.  |
| Regulatory Liabilities   | 15.3                                     | Increases in regulatory liabilities were due to increases to site restoration costs of \$12.7 and in AESO charges deferrals of \$2.9. These were partially offset by a \$0.3 decrease in other regulatory liabilities.   |
| Future Income Taxes  | 12.7                                     | Future income taxes increased due to a continuing increase in temporary differences between the carrying value of assets and liabilities and their values for income tax purposes.   |
| Long-term Debt   | (22.7)                                   | Long-term debt decreased due to the reclassification of the syndicated credit facility which matures in May 2012 to short-term debt. This was partially offset by a decrease of \$0.3 in transaction costs.  |

## SOURCES AND USES OF LIQUIDITY AND CAPITAL RESOURCES

The Corporation's primary sources of liquidity and capital resources are the following:

- funds generated from operations;
- the issuance and sale of debt instruments;
- bank financing and operating lines of credit; and
- equity contributions from the Corporation's parent.

## STATEMENT OF CASH FLOWS

| (\$ thousands)               | Three Months Ended June 30 |          |                         | Six Months Ended June 30 |           |                         |
|------------------------------|----------------------------|----------|-------------------------|--------------------------|-----------|-------------------------|
|                              | 2011                       | 2010     | Increase/<br>(Decrease) | 2011                     | 2010      | Increase/<br>(Decrease) |
| Cash, beginning of period    | –                          | –        | –                       | –                        | –         | –                       |
| Cash provided from (used in) |                            |          |                         |                          |           |                         |
| Operating activities         | 53,737                     | 41,945   | 11,792                  | 123,901                  | 78,633    | 45,268                  |
| Investing activities         | (73,127)                   | (79,422) | 6,295                   | (147,211)                | (136,912) | (10,299)                |
| Financing activities         | 19,390                     | 37,477   | (18,087)                | 23,310                   | 58,279    | (34,969)                |
| Cash, end of period          | –                          | –        | –                       | –                        | –         | –                       |

### Operating Activities

For the three months ended June 30, 2011, net cash provided from operating activities was \$53.7 million, which was \$11.8 million higher than the same period in 2010. Cash receipts were \$12.2 million higher than the same period in 2010 primarily due to an increase in cash from net transmission receipts and payments, as well as an increase in distribution rates and customer counts. Changes in other receivables and payables resulted in net cash inflows of approximately \$12.6 million, which consisted of \$11.8 million due to net increases in accounts payables relating to transmission connected projects and other net changes of \$0.8 million. These were partially offset by an increase in cash payments of \$8.1 million, income taxes paid of \$1.8 million and interest paid of \$3.1 million.

For the six months ended June 30, 2011, net cash provided from operating activities was \$123.9 million, which was \$45.3 million higher than the same period in 2010. Cash receipts were \$43.4 million higher than the same period in 2010 primarily due to an increase in cash from net transmission receipts and payments, as well as an increase in distribution rates and customer counts. Changes in other receivables and payables resulted in net cash inflows of approximately \$13.8 million, which consisted of a net increase of \$5.5 million resulting from a decrease in net payments to Scotiabank compared to 2010 relating to the sale of the 2007 AESO deferral, net cash inflows of \$6.7 million due to net increases in accounts payables relating to transmission connected projects and other net changes of \$1.6 million. These were partially offset by an increase in cash payments of \$7.0 million, income taxes paid of \$1.8 million and interest paid of \$3.1 million.

Management believes that the Corporation will continue to be a rate-regulated entity allowing for recovery of its prudently incurred regulated costs and a reasonable return on equity. In this environment the Corporation should be able to pay all operating costs and interest expense out of operating cash flows, with some residual available for dividend payments to the parent company and/or capital expenditures. If there is continued growth, the Corporation will require additional financing in the form of debt and equity to fund a portion of its capital expenditures. In addition, management expects that the Corporation will continue to provide these distribution services to the customers in its service territory for the foreseeable future and, as such, when the current debt instruments mature the Corporation would be required to issue new debt to repay the principal obligations, as there would still be a requirement for that capital to support the assets of the Corporation. There are no required long-term debt principal repayments in 2011.

## Investing Activities

| (\$ thousands)                 | Three Months Ended June 30 |         |                         | Six Months Ended June 30 |          |                         |
|--------------------------------|----------------------------|---------|-------------------------|--------------------------|----------|-------------------------|
|                                | 2011                       | 2010    | Increase/<br>(Decrease) | 2011                     | 2010     | Increase/<br>(Decrease) |
| Capital expenditures           |                            |         |                         |                          |          |                         |
| New customers                  | 44,480                     | 44,167  | 313                     | 80,147                   | 80,131   | 16                      |
| Capital upgrades/replacements  | 21,090                     | 13,580  | 7,510                   | 40,103                   | 28,662   | 11,441                  |
| Facilities, vehicles and other | 10,486                     | 19,509  | (9,023)                 | 24,767                   | 28,300   | (3,533)                 |
| Information technology         | 2,977                      | 2,880   | 97                      | 6,439                    | 5,104    | 1,335                   |
| AESO contributions             | 9,587                      | 3,393   | 6,194                   | 19,575                   | (171)    | 19,746                  |
| Gross capital expenditures     | 88,620                     | 83,529  | 5,091                   | 171,031                  | 142,026  | 29,005                  |
| Less: customer contributions   | (16,751)                   | (9,114) | (7,637)                 | (27,271)                 | (18,103) | (9,168)                 |
| Net capital expenditures       | 71,869                     | 74,415  | (2,546)                 | 143,760                  | 123,923  | 19,837                  |

The Corporation's utility operations are capital intensive. For the three months ended June 30, 2011, the Corporation had gross capital expenditures of approximately \$88.6 million compared to \$83.5 million for the same period in 2010. Capital expenditures related to new customers increased by \$0.3 million compared to the same period in 2010, primarily as a result of an increase in demand for oil and gas services and small general services. Capital expenditures related to capital upgrades and replacements increased by \$7.5 million compared to the same period in 2010, mostly due to an increase in substation upgrades, system improvements and planned maintenance. Capital expenditures related to facilities, vehicles and other decreased by \$9.0 million compared to the same period in 2010. There was a decrease of \$11.4 million related to meters and meter equipment due to lower expenditures related to the automated metering project in 2011. As well, there were no system purchases in 2011 compared to \$3.8 million in 2010. These decreases were partially offset by increases in other expenditures of \$4.8 million related principally to the change in the balance of uninstalled transformers from the second quarter in 2010. Capital expenditures related to AESO contributions increased by \$6.2 million.

For the six months ended June 30, 2011, the Corporation had gross capital expenditures of approximately \$171.0 million, compared to \$142.0 million for the same period in 2010. Capital expenditures related to capital upgrades and replacements increased by \$11.4 million compared to the same period in 2010. Capital expenditures related to facilities, vehicles, and other decreased by \$3.5 million compared to the same period in 2010. Capital expenditures related to information technology increased by \$1.3 million. Capital expenditures related to AESO contributions increased by \$19.7 million.

It is expected that ongoing capital expenditures will be financed from funds generated by operating activities, drawings on the syndicated credit facility, proceeds from new indebtedness, and equity contributions from Fortis Alberta Holdings Inc.

### Capital Expenditures

As an electric utility, the Corporation is obligated to provide a safe and reliable service to its customers. The Corporation has forecast total gross capital expenditures for 2011 of approximately \$394.3 million including \$123.5 million for customer driven capital, \$130.9 million for capital upgrades and improvements, \$20.3 million for metering, and \$119.6 million for other capital. Included in other capital is \$14.4 million for information technology, \$11.3 million for facilities, \$76.5 million for contributions to AESO projects and \$17.4 million for other capital projects. In addition, the Corporation expects to receive forecast customer contributions of approximately \$31.9 million. These estimates are based upon detailed forecasts, which are based upon numerous assumptions such as customer demand, weather, cost of labour and material, as well as other factors that could change and cause actual results to differ from these forecasts.

Cash used in investing activities was \$1.3 million higher than net capital expenditures for the three months ended June 30, 2011 and \$3.5 million higher for the six months ended June 30, 2011 as illustrated by the following table:

| (\$ thousands)  | Three Months Ended<br>June 30, 2011 | Six Months Ended<br>June 31, 2011 |
|---|-------------------------------------|-----------------------------------|
| Net capital expenditures  | 71,869                              | 143,760                           |
| Changes in:   |                                     |                                   |
| Non-cash working capital  | 3,986                               | 10,752                            |
| Costs of removal, net of salvage proceeds, from the sale of property, plant and equipment and AFUDC | 4,023                               | 4,157                             |
| Capitalized depreciation  | (1,240)                             | (2,379)                           |
| Materials and supplies  | (5,372)                             | (8,583)                           |
| Change in employee loans  | (139)                               | (496)                             |
| Cash used in investing activities   | 73,127                              | 147,211                           |

### Financing Activities

For the three months ended June 30, 2011, net cash provided from financing activities was \$19.4 million, which was \$18.1 million lower than the same period in 2010. This decrease was primarily due to a \$21.8 million decrease in net debt issuances. In addition, dividends paid to Fortis Alberta Holdings Inc. for the three months ended June 30, 2011 were \$1.3 million higher than the same period in 2010. These decreases were partially offset as equity contributions increased by \$5.0 million over the same period in 2010.

For the six months ended June 30, 2011, net cash provided from financing activities was \$23.3 million, which was \$35.0 million lower than the same period in 2010. The difference was primarily due to a decrease in net debt issuances of \$37.5 million. In addition, dividends paid to Fortis Alberta Holdings Inc. for the six months ended June 30, 2011 were \$2.5 million higher than the same period in 2010. These decreases were partially offset as equity contributions increased by \$5.0 million over the same period in 2010.

The Corporation anticipates it will be able to meet interest payments on outstanding indebtedness from internally generated funds but expects to rely upon the proceeds of new indebtedness to meet the principal obligations when due.

## COMMITMENTS

### Pension Contribution Obligations

The Corporation makes minimum pension contributions into a defined benefit component of the Corporation's pension plan for certain employees, which according to the Actuarial Valuation for Funding Purposes as at December 31, 2010 amounts to approximately \$2.8 million in 2011 and 2012, and \$2.3 million in 2013. Future actuarial valuations will establish the funding obligations for subsequent years, which could be materially different depending upon market conditions. The next required funding valuation is expected to be completed as at December 31, 2013.

## CAPITAL MANAGEMENT

The Corporation's objectives when managing capital are to ensure ongoing access to capital to allow it to build and maintain the electrical distribution system within the Corporation's service territory. To ensure this access to capital, the Corporation targets a long-term capital structure that includes approximately 59% long-term debt and 41% equity, which is consistent with the Generic Cost of Capital Decision. This targeted capital structure is after eliminating the effects of goodwill, the regulatory tax basis adjustment and other items that do not impact the deemed regulatory capital structure. This ratio is maintained by the Corporation through the issuance from time to time of bonds or other evidences of indebtedness, and/or equity contributions by Fortis Alberta Holdings Inc.

### Summary of Long-term Capital Structure

|                               | June 30, 2011 |       | December 31, 2010 |       |
|-------------------------------|---------------|-------|-------------------|-------|
|                               | \$ millions   | %     | \$ millions       | %     |
| Long-term debt <sup>(a)</sup> | 1,059.2       | 55.3  | 1,082.2           | 57.3  |
| Shareholder's equity          | 857.7         | 44.7  | 807.5             | 42.7  |
| Total                         | 1,916.9       | 100.0 | 1,889.7           | 100.0 |

Note:

- a. The June 30, 2011, balance does not include transaction costs of \$8.5 million (December 31, 2010 – \$8.7 million).

In the management of capital, the Corporation includes shareholder's equity (excluding accumulated other comprehensive income), short-term and long-term debt, and cash and cash equivalents in the definition of capital.

As at June 30, 2011, the Corporation has externally imposed capital requirements by virtue of the Trust Indenture and the syndicated credit facility to which it is subject that limit the amount of debt that can be incurred relative to equity. The Corporation is in compliance with these externally imposed capital requirements as at June 30, 2011.

The Corporation has an unsecured syndicated credit facility with an amount available of \$200.0 million, and with the consent of the lenders, the amount can be increased to \$250.0 million. The maturity date of this facility is May 2012. Drawings under the syndicated credit facility are available by way of prime loans, bankers' acceptances and letters of credit. Prime loans issued under the syndicated credit facility bear an interest rate of prime. Bankers' acceptances issued under the syndicated credit facility are issued at the applicable bankers' acceptance discount rate plus a stamping fee calculated at 0.375%. The average interest rate for the six months ended June 30, 2011 on the syndicated credit facility was 1.6% (six months ended June 30, 2010 - 0.8%). As at June 30, 2011, there were \$40.0 million in drawings under the facility for banker's acceptances (December 31, 2010 - \$23.0 million), and there was \$56.6 million drawn in letters of credit (December 31, 2010 - \$56.6 million).

An unsecured demand facility of \$10.0 million was available to the Corporation as at June 30, 2011. This facility bears an interest rate on all drawings equal to prime. There were no drawings on this facility as at June 30, 2011 (December 31, 2010 - \$1.9 million which were included in short-term debt).

## OUTSTANDING SHARES

Authorized – unlimited number of:

- Common shares
- Class A common shares
- First Preferred non-voting shares, redeemable, cumulative dividend at 10% of the redemption price. Subject to applicable law, the Corporation shall have the right to redeem, at any time, all or any part of the then outstanding first preferred shares for \$348.9 million together with any accrued and unpaid dividends up to the redemption date.

Issued – 63 Class A common shares, with no par value.

## RELATED PARTY TRANSACTIONS

In the normal course of business, the Corporation transacts with its parent and other related companies under common control. The amounts included in accounts receivable and accounts payable for related parties were measured at the exchange amount and are as follows:

| (\$ thousands)   | Included in Accounts Receivable |                   | Included in Accounts Payable |                   |
|--|---------------------------------|-------------------|------------------------------|-------------------|
|  | June 30, 2011                   | December 31, 2010 | June 30, 2011                | December 31, 2010 |
| FortisBC Inc.  | 22                              | 76                | –                            | 7                 |
| Fortis   | –                               | 12                | 598                          | 594               |
| FortisBC Pacific Holdings Inc.   | 2                               | –                 | –                            | –                 |
| Newfoundland Power   | 5                               | –                 | –                            | –                 |
| Fortis Turks and Caicos Inc.   | 467                             | 15                | –                            | –                 |
| Maritime Electric Company, Limited   | 7                               | –                 | –                            | –                 |
| FortisBC Holdings Inc.   | 3                               | –                 | –                            | –                 |
| Housing loans to officers of the Corporation <sup>(a)</sup>                      | 700                             | 750               | –                            | –                 |
| Stock option loans to officers of the Corporation <sup>(b)</sup>                 | 167                             | 814               | –                            | –                 |
| Employee share purchase plan loans to officers of the Corporation <sup>(c)</sup> | 28                              | 14                | –                            | –                 |
| Employee computer loans to officers of the Corporation <sup>(d)</sup>            | 2                               | 1                 | –                            | –                 |
|  | 1,403                           | 1,682             | 598                          | 601               |
| Less: current portion  | 536                             | 117               | 598                          | 601               |
| Long-term portion  | 867                             | 1,565             | –                            | –                 |

Notes:

- The Corporation has granted housing and relocation loans to officers of the Corporation. The loans are interest-free for a period of three to six years from the loan grant date after which interest will accrue at the rate of prime plus 0.5%. The total amount of the loans must be repaid within 10 years of the loan grant date. The loans are secured by mortgages on the residences purchased by the officers.
- The Corporation has granted stock options loans to officers of the Corporation for purposes of exercising their Fortis stock options. Each loan bears interest equal to the amount of the dividends received on the shares. The total amount of each loan must be repaid within 10 years of the loan grant date. Each loan is secured by the share certificates held by the officer.
- The amounts receivable under the employee share purchase plan are for loans to officers of the Corporation under the employee share purchase plan. These loans are taken on an interest-free basis and must be repaid in full within one year of the share purchase date.
- The amounts receivable under the computer loans are for loans to officers of the Corporation under the employee personal computer purchase program. These loans are taken on an interest-free basis and must be repaid in full within three years of the loan issue date.

The Corporation bills related parties on terms and conditions consistent with billings to third parties. These require amounts to be paid on a net 30 day basis with interest on overdue amounts charged at a rate of 1.5% per month (19.5% per annum). Terms and conditions on amounts billed to the Corporation by related parties are net 30 days with interest being charged on any overdue amounts.

The amounts included in other revenue and operating costs for related parties for the three months ended June 30, 2011 and 2010 were measured at the exchange amount and are as follows:

| (\$ thousands)                     | Included in Other Revenue |               | Included in Operating Costs |               |
|------------------------------------|---------------------------|---------------|-----------------------------|---------------|
|                                    | June 30, 2011             | June 30, 2010 | June 30, 2011               | June 30, 2010 |
| FortisBC Inc.                      | 34                        | 21            | 6                           | 6             |
| Fortis                             | —                         | 57            | 708                         | 740           |
| FortisBC Pacific Holdings Inc.     | 3                         | —             | —                           | —             |
| Newfoundland Power                 | 5                         | —             | 2                           | —             |
| Fortis Turks and Caicos Inc.       | 86                        | —             | —                           | —             |
| Maritime Electric Company, Limited | 15                        | 3             | —                           | —             |
| FortisOntario Inc.                 | —                         | —             | 3                           | —             |
| FortisBC Holdings Inc.             | 3                         | —             | —                           | —             |
| <b>Total</b>                       | <b>146</b>                | <b>81</b>     | <b>719</b>                  | <b>746</b>    |

The amounts included in other revenue and operating costs for related parties for the six months ended June 30, 2011 and 2010 were measured at the exchange amount and are as follows:

| (\$ thousands)                     | Included in Other Revenue |               | Included in Operating Costs |               |
|------------------------------------|---------------------------|---------------|-----------------------------|---------------|
|                                    | June 30, 2011             | June 30, 2010 | June 30, 2011               | June 30, 2010 |
| FortisBC Inc.                      | 77                        | 61            | 14                          | 12            |
| Fortis                             | —                         | 60            | 1,448                       | 1,364         |
| FortisBC Pacific Holdings Inc.     | 6                         | 8             | —                           | —             |
| Newfoundland Power                 | 5                         | —             | 2                           | —             |
| Fortis Turks and Caicos Inc.       | 466                       | —             | —                           | —             |
| Maritime Electric Company, Limited | 15                        | 5             | —                           | —             |
| FortisOntario Inc.                 | —                         | —             | 7                           | —             |
| FortisBC Holdings Inc.             | 3                         | —             | 1                           | —             |
| Fortis Properties Inc.             | —                         | —             | —                           | 2             |
| <b>Total</b>                       | <b>572</b>                | <b>134</b>    | <b>1,472</b>                | <b>1,378</b>  |

**FortisBC Inc.** – billed the Corporation in 2011 for charges consisting of pension costs, as well as travel and accommodation expenses for board meetings, air fare and meals. In 2011, the Corporation provided metering services, employee services, information technology services and material sales to FortisBC Inc.

**Fortis** – billed the Corporation in 2011 for charges relating to corporate governance expenses, stock-based compensation costs, subscription expenses, consulting services and travel and accommodation expenses.

**FortisBC Pacific Holdings Inc. (formerly Fortis Pacific Holdings Inc.)** – received metering services from the Corporation in 2011. Fortis Pacific Holdings Inc. was renamed to FortisBC Pacific Holdings Inc. effective March 1, 2011.

**Newfoundland Power Inc.** – billed the Corporation for consultant costs on risk management services in 2011. In 2011 the Corporation provided employee services to Newfoundland Power Inc.

**Fortis Turks and Caicos Inc.** – received employee services from the Corporation in 2011.

**Maritime Electric Company, Limited** – in 2011 the Corporation provided metering services to Maritime Electric Company, Limited.

**FortisOntario Inc.** – billed the Corporation in 2011 for charges relating to travel and accommodation expenses for board meetings.

**FortisBC Holdings Inc. (formerly Terasen Inc.)** – billed the Corporation in 2011 for consulting costs. In 2011 the Corporation provided employee services to FortisBC Holdings Inc. Terasen Inc. was renamed to FortisBC Holdings Inc. effective March 1, 2011.

All services provided to or received from related parties were billed on a cost-recovery basis.

## FINANCIAL INSTRUMENTS

### Designation and Valuation of Financial Instruments

CICA Handbook Section 3855, *Financial Instruments – Recognition and Measurement*, requires an entity to designate its financial instruments into one of the following five categories: 1) loans and receivables, 2) assets held-to-maturity, 3) assets available-for-sale, 4) other financial liabilities, and 5) held-for-trading assets and liabilities. The Corporation did not designate any of its financial assets or liabilities as held-to-maturity, available-for-sale or held for trading as at June 30, 2011.

The Corporation has elected to designate its financial instruments as follows:

| (\$ thousands)   | June 30, 2011  |                      | December 31, 2010 |                      |
|--|----------------|----------------------|-------------------|----------------------|
|  | Carrying Value | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| Loans and receivables                                      |                |                      |                   |                      |
| Accounts receivable (short-term) <sup>(a)(b)</sup>         | 118,849        | 118,849              | 113,748           | 113,748              |
| Accounts receivable (long-term) <sup>(a)</sup>             | 897            | 897                  | 1,584             | 1,584                |
| Other financial liabilities                                |                |                      |                   |                      |
| Accounts payable and accrued liabilities <sup>(a)(c)</sup> | 138,133        | 138,133              | 133,760           | 133,760              |
| Short-term debt <sup>(a)(f)</sup>                          | 45,690         | 45,690               | 9,352             | 9,352                |
| Long-term debt <sup>(d)(e)</sup>                           | 1,059,228      | 1,194,569            | 1,082,207         | 1,223,015            |

**Notes:**

- Due to the nature and/or short maturity of these financial instruments, carrying value approximated fair value.
- The December 31, 2010 balance does not include GST receivable of \$0.4 million.
- Included within accounts payable, accrued and other liabilities in the Balance Sheet. The June 30, 2011 balance does not include GST payable of \$1.3 million.
- The June 30, 2011 balance does not include transaction costs of \$8.5 million (December 31, 2010 - \$8.7 million).
- The fair value of the long-term debt is estimated based on the quoted market prices for the same or similarly rated issues for debt of the same or similar remaining maturities.
- The June 30, 2011 balance does not include transaction costs of \$0.1 million.

### Derivatives

The Corporation currently does not have any stand-alone derivative instruments as defined under Section 3855. The Corporation conducted a review of contractual agreements for embedded derivatives.

Under Section 3855, an embedded derivative must meet three specific criteria to be accounted for under the Section. For contracts entered into by the Corporation, all potential embedded derivatives reviewed by the Corporation were closely related with the economic characteristics and risks of the underlying contract, had no notional amount that could be used to measure the instrument, or had no value.

## Risk Management

Exposure to counterparty credit risk, interest rate risk and liquidity risk arises in the normal course of the Corporation's business. The Corporation currently does not enter into derivative financial instruments to reduce exposure to fluctuations in any of the risks impacting the Corporation's operations. The Corporation enters into financial instruments to finance the Corporation's operations in the normal course of business.

### Counterparty Credit Risk

The Corporation defines counterparty credit risk as the financial risk associated with the non-performance of contractual obligations by counterparties. The Corporation extends credit to select counterparties in its role as an electrical system distribution provider.

The Corporation monitors its credit exposure in accordance with the Terms and Conditions of Distribution Access Service as approved by the AUC. The following table provides information on the counterparties that the Corporation extends credit to with respect to its distribution tariff billings as at June 30, 2011.

| Credit Rating           | Number of Counterparties | Gross Exposure<br>(\$ thousands) | Exposure<br>(\$ thousands) |
|-------------------------|--------------------------|----------------------------------|----------------------------|
| AAA to AA (low)         | 1                        | 1,907                            | –                          |
| A (high) to A (low)     | 8                        | 4,878                            | –                          |
| BBB (high) to BBB (low) | 9                        | 17,226                           | –                          |
| Not rated               | 32                       | 108,749                          | 7,932                      |
| Total                   | 50                       | 132,760                          | 7,932                      |

Gross exposure represents the projected value of retailer billings over a 60-day period. As outlined in the Terms and Conditions of Distribution Access Service, the Corporation is required to minimize its gross exposure to retailer billings by obtaining an acceptable form of prudential. These acceptable forms of prudential include a cash deposit, bond, letter of credit, an investment grade credit rating from a major rating agency, or a financial guarantee from an entity with an investment grade credit rating.

Retailers with investment grade credit ratings have the exposure shown as nil since the rating serves to reduce the amount of prudential required under the Terms and Conditions of Distribution Access Service. For retailers that do not have an investment grade credit rating, the exposure is calculated as the projected value of billings over a 60-day period less the prudential held by the Corporation.

Volatility in the global capital markets and a slowdown in the Alberta economy could cause the credit quality of some of the Corporation's customers to decrease. In the event that the prudential obtained by the Corporation under the Terms and Conditions of Distribution Access Service is not sufficient to cover a loss due to non-payment from the Corporation's counterparties, the Corporation would review all other options available to collect the non-payment. However, these options would not ensure that a loss could be avoided by the Corporation.

No allowance for doubtful accounts has been recorded by the Corporation. The aging analysis of the Corporation's accounts receivable is as follows:

| (\$ thousands)            | June 30, 2011 |
|---------------------------|---------------|
| Not past due              | 115,960       |
| Past due 0-60 days        | 2,665         |
| Past due 61 days and over | 224           |
|                           | 118,849       |

### Interest Rate Risk

The Corporation defines interest rate risk as the financial risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Corporation's debentures bear fixed interest

rates, thereby minimizing cash flow variability due to interest rate exposures. The fair value of the fixed rate debentures fluctuates as market interest rates change. However, the Corporation plans to hold these debentures until maturity and applies in its rate applications to recover the actual interest rates on the debentures, thereby mitigating the risk of these fluctuations. The drawings under the Corporation's syndicated credit facility are at current market short-term interest rates, exposing the Corporation to some cash flow risk, but minimal fluctuations in fair value.

A change in the Corporation's interest rates results in interest rate exposure for drawings under the syndicated credit facility. The Corporation has determined that a change in interest rates of an increase of 200 basis points and a decrease of 25 basis points represents a reasonably possible financial risk, and has prepared the following sensitivity analysis to represent the impacts of a change on net income for the three and six months ended June 30, 2011:

| (\$ thousands)                    | Three months ended<br>June 30, 2011 |                             | Six months ended<br>June 30, 2011 |                             |
|-----------------------------------|-------------------------------------|-----------------------------|-----------------------------------|-----------------------------|
|                                   | 25 basis point<br>decrease          | 200 basis<br>point increase | 25 basis point<br>decrease        | 200 basis<br>point increase |
| Increase (decrease) in net income | 35                                  | (279)                       | 52                                | (415)                       |

Further, changes to the credit rating of the Corporation also represent a financial risk. The Corporation has debt facilities, which have interest rate and fee components that are sensitive to the credit rating of the Corporation. The Corporation is rated by Moody's Investors Service ("Moody's"), Dominion Bond Rating Service Limited ("DBRS") and Standard and Poor's ("S&P") and a change in rating by any of these rating agencies could potentially increase or decrease the interest expense of the Corporation.

As at June 30, 2011, the Corporation was rated by Moody's at Baa1, by S&P at A-, and by DBRS at A (low). A downward one notch change in the rating by any of DBRS, Moody's or S&P on January 1, 2011 could potentially have increased interest expense under these debt facilities by approximately \$22 thousand for the three months ended June 30, 2011 and \$40 thousand for the six months ended June 30, 2011. An upward one notch change in the rating by any of DBRS, Moody's or S&P on January 1, 2011 could potentially have decreased interest expense under these debt facilities by approximately \$15 thousand for the three months ended June 30, 2011 and \$29 thousand for the six months ended June 30, 2011.

### Liquidity Risk

The Corporation defines liquidity risk as the financial risk that the Corporation will encounter challenges in meeting obligations associated with financial liabilities. The Corporation anticipates it will be able to meet interest payments on outstanding indebtedness from internally generated funds but expects to rely upon the proceeds of new indebtedness to meet the principal obligations when due.

Volatility experienced in the global capital markets may increase the cost of issuance of long-term capital by the Corporation. Capital market volatility may also impact the Corporation's future funding obligations and/or pension expense associated with its defined benefit pension plan. There are a number of risks associated with the Corporation's defined benefit pension plan including: 1) there is no assurance that the Corporation's defined benefit pension plan will earn the assumed rate of return, 2) market driven changes may result in changes in the discount rates and other variables, which would result in the Corporation being required to make contributions in the future that differ from the estimates, and 3) there is measurement uncertainty incorporated into the actuarial valuation process. These risks are expected to be mitigated as the Corporation makes application in rates to collect from customers the actual cash payments into the Corporation's defined benefit pension plan and defined contribution pension plans. Therefore, an increase or decrease in the Corporation's future funding obligations and/or pension expense associated with either plan is expected to be collected or refunded in future rates, subject to forecast risk. In December 2009, the defined benefit assets were invested in a 100% long-term bond fund, which significantly reduces the forecast risk on future defined benefit funding obligations.

The Corporation's outstanding financial liabilities as at June 30, 2011, include short-term debt, accounts payable and accrued liabilities, and long-term debt. The Corporation expects to settle its financial liabilities relating to short-term debt and accounts payable and accrued liabilities in accordance with their contractual terms of repayment, which are generally within one year.

The following table summarizes the number of years to maturity of the principal outstanding and interest payments on the Corporation's long-term debt, which is composed of senior unsecured debentures, as at June 30, 2011:

| (\$ thousands)                                | 1–5 Years | 6–10 Years | > 10 Years | Total     |
|---|-----------|------------|------------|-----------|
| Senior unsecured debentures <sup>(a)(b)</sup> |           |            |            |           |
| - Principal payments                          | 200,000   | –          | 860,000    | 1,060,000 |
| - Interest payments                           | 282,068   | 244,758    | 919,365    | 1,446,191 |
| Total   | 482,068   | 244,758    | 1,779,365  | 2,506,191 |

Notes:

- a. The June 30, 2010 balance does not include transaction costs of \$8.5 million.
- b. Payments are shown after amortization of discounts.

## SIGNIFICANT ACCOUNTING ESTIMATES

Certain estimates are necessary since the regulatory environment in which the Corporation operates often requires amounts to be recorded at estimated values until finalization and adjustments, if any, are determined pursuant to subsequent regulatory decisions or other regulatory proceedings. Due to the inherent uncertainty in making such estimates, actual results reported in future periods could differ materially from those estimated. In addition, certain estimates not associated with regulatory decisions are also subject to finalization and adjustments. There were no material changes to the items that the Corporation's significant accounting estimates apply to during the period ended June 30, 2011 from those disclosed in the MD&A for the year ended December 31, 2010. Interim financial statements necessarily employ a greater use of estimates than the annual financial statements.

## FUTURE CHANGES IN ACCOUNTING POLICIES

### Adoption of New Accounting Standards

The pace and outcome of the International Accounting Standards Board's ("IASB") project with respect to rate-regulated activities have put Canadian rate-regulated entities at a significant disadvantage in terms of their ability to adopt International Financial Reporting Standards ("IFRS") as of January 1, 2011. Accordingly, the Canadian Accounting Standards Board ("AcSB") has provided qualifying entities with an option to defer their changeover to IFRS by one year. The necessary amendments to the CICA Handbook were published by the AcSB in October 2010.

While the Corporation's IFRS Conversion Project had proceeded as planned in preparation for the adoption of IFRS on January 1, 2011, the Corporation qualified for the optional one-year deferral and, therefore, will continue to prepare its financial statements in accordance with Part V of the CICA Handbook for all interim and annual periods ending on or before December 31, 2011.

Due to the continued uncertainty around the timing and adoption of a rate-regulated accounting standard by the IASB, the Corporation is currently evaluating the option of adopting Generally Accepted Accounting Principles in the United States ("US GAAP") effective January 1, 2012.

The Corporation is currently not a Securities and Exchange Commission ("SEC") Issuer. Therefore, on June 6, 2011 Fortis filed an application with the Ontario Securities Commission (the "OSC") seeking relief, pursuant to National Policy 11-203 – Process for Exemptive Relief Applications in Multiple Jurisdictions, to permit Fortis and its reporting issuer subsidiaries (including the Corporation) to prepare their financial statements in accordance with US GAAP without qualifying as an SEC Issuer ("the Exemption"). On June 9, 2011 the OSC issued its decision and granted the Exemption for financial years commencing on or after January 1, 2012 but before January 1, 2015, and interim periods therein. The Exemption will terminate in respect of financial statements for annual and interim periods commencing on or after the earlier of: (i) January 1, 2015; or (ii) the date on which the Corporation ceases to have activities subject to rate regulation.

The Corporation's application of Canadian GAAP currently is based on principles generally consistent with US GAAP for guidance on accounting for rate-regulated activities, which allows the economic impact of rate-regulated activities to be recognized in the financial statements in a manner consistent with the timing by which amounts are reflected in customer rates.

The Corporation has developed a three-phase plan to evaluate the option of adopting US GAAP effective January 1, 2012. The following is an overview of the activities under each phase, and their current status.

***Phase I - Scoping and Diagnostics:*** This phase consists of project initiation and awareness; project planning and resourcing; identification of high-level differences between US GAAP and Canadian GAAP to highlight areas where detailed analysis is needed to determine and conclude as to the nature and extent of impacts. External accounting and legal advisors were engaged during this phase to assist the Corporation's internal US GAAP conversion team and to provide technical input and expertise as required. Phase I is substantially complete.

***Phase II - Analysis and Development:*** This phase consists of detailed diagnostics and evaluation of the financial impacts of adopting US GAAP based on the high-level assessment conducted under Phase I; identification and design of any new operational or financial business processes; initial staff training and audit committee orientation; and development of required solutions to address identified issues. Phase II of the plan is scheduled for completion by the fall of 2011.

***Phase III - Implementation and Review:*** This phase consists of implementation of the changes required by the Corporation to prepare and file its financial statements based on US GAAP beginning in 2012 and communication of the associated impacts. Phase III is expected to conclude by year end 2011, if the Corporation pursues the plan and issues its first annual audited US GAAP statements for the year ended December 31, 2012. Commencing in the first quarter of 2012, the plan to evaluate this option would have the Corporation's unaudited interim financial statements prepared in accordance with US GAAP.

#### **Financial Statement Impacts**

***Employee future benefits:*** Under Canadian GAAP, the accrued benefit asset or liability associated with defined benefit plans is recognized on the balance sheet with a reconciliation of the recognized asset or liability to the funded or unfunded status being disclosed in the notes to the financial statements. The accrued benefit asset or liability excludes unamortized balances related to past service costs, actuarial gains or losses and transitional obligations which have not yet been expensed.

US GAAP requires recognition of the funded or unfunded status of defined benefit plans on the balance sheet, with the opening unamortized balances related to past service costs, actuarial gains or losses and transitional obligations recognized on the balance sheet as a component of accumulated other comprehensive income. Changes to past service costs, actuarial gains or losses and transitional obligations which are not immediately recognized as components of net pension expense are required to be recognized in other comprehensive income. Entities with activities subject to rate regulation would recognize the opening unamortized balances as regulatory assets or liabilities for recovery from or refund to customers in future rates, with subsequent changes to these balances recognized as net pension expense, where required by the regulator, or otherwise as a change in the regulatory asset or liability. Therefore, upon adoption of US GAAP, the Corporation will recognize the unfunded or funded status of its defined benefit plans on the balance sheet with the unamortized balances recognized as regulatory assets or liabilities except as discussed below.

The Corporation has historically recovered its other post-employment benefit ("OPEB") costs on a cash basis, as opposed to an accrual basis, and will likely continue to do so as ordered by its regulator. Therefore, the Corporation's regulatory asset associated with OPEB costs does not meet the criteria for recognition under US GAAP.

The following table summarizes additional difference between Canadian GAAP and US GAAP in the accounting for defined benefit plans.

|                    | <b>Canadian GAAP</b>  | <b>US GAAP</b>  |
|--------------------|---|---|
| Measurement Date   | Allows the use of a measurement date up to three months prior to the date of an entity's fiscal year end.                                 | Only allows the use of a measurement date equal to the date of an entity's fiscal year end. |
| Attribution Period | Allows the use of an attribution period that extends beyond the date when the credited service period ends, under specific circumstances. | Only allows the use of an attribution period up to the date when credited service ends.     |

The above items do not represent a complete list of expected differences between US GAAP and Canadian GAAP. Analysis remains on-going and additional areas where the Corporation's financial statements may be materially impacted could be identified prior to the Corporation's voluntary preparation and filing, in accordance with US GAAP, of its annual audited financial statements for the year ending December 31, 2011. Any additional areas where significant adjustments may be required will be disclosed as they are determined.

The quantification and reconciliation of the Corporation's financial statements from Canadian GAAP to US GAAP for 2010 is scheduled for completion by September 30, 2011. The quantification and reconciliation of the Corporation's financial statements from Canadian GAAP to US GAAP for 2011 interim and annual reporting periods is scheduled for completion by March 31, 2012.

## BUSINESS RISK

### Legal Proceedings

The Corporation is subject to various legal proceedings and claims that arise in the ordinary course of business operations. The Corporation believes that the amount of liability, if any, from these actions would not have a material effect on the Corporation's financial position or results of operations.

## OUTLOOK

### Performance Based Regulation ("PBR")

The AUC has initiated a process to reform utility rate regulation in Alberta. The AUC has expressed its intention to apply a PBR formula to distribution service rates. A PBR regime can create incentives for a utility to improve efficiencies similar to a competitive market and to share in economic and/or other benefits with customers. The Corporation is currently assessing PBR and will participate fully in the AUC process.

On July 22, 2011, the Corporation, along with other distribution utilities operating under the AUC's jurisdiction, submitted their PBR proposals to the AUC. The Corporation's submission outlines its view as to how PBR should be implemented at the Corporation.

### Generic Cost of Capital Hearing

The regulated ROE for 2011 was approved as 9.0% on an interim basis in AUC Decision 2009-216. The AUC issued a Notice of Commission-Initiated Proceeding on December 16, 2010 to finalize the 2011 ROE and capital structure and consider whether a return to a formula-based approach for setting ROE beginning in 2012 is warranted. In the absence of a formula-based approach, the Commission is expected to consider how the ROE will be set for 2012. The Corporation submitted evidence in conjunction with a group of Alberta utilities in the first quarter. The hearing has been completed and a decision is expected to be reached in the fourth quarter of 2011.

### Review and Variance Application

In the Corporation's 2010 and 2011 Phase I DTA proceedings before the AUC, the Corporation requested to update the 2010/2011 forecast for the capital cost of the automated metering project, bringing the total project forecast to \$125.7 million. The AUC concluded that an amount of \$104.3 million for the metering project formed part of the 2008/2009 Negotiated Settlement Agreement ("NSA") approved in Decision 2008-011 and therefore did not approve the updated forecast. The Corporation filed a Review and Variance Application with the AUC and a Leave to Appeal with the Alberta Court of Appeal regarding the AUC's reading of Decision 2008-011, the interpretation thereof and the NSA included therein. The AUC issued Decision 2010-554 regarding the Review and Variance Application approving a hearing into the prudence of the capital expenditures above \$104.3 million, and in Decision 2011-233 the AUC concluded that the full amount of the forecast \$125.7 million can be included in rates.

The Corporation's Leave to Appeal of Decision 2010-309 was adjourned pending determination of the Review and Variance. The Utilities Consumer Advocate has filed with the Alberta Court of Appeal Leave to Appeal requests in respect of both Decision 2010-554 and 2011-233. These matters remain to be determined.

### **CAREA Application**

On October 1, 2010, the CAREA filed an Application with the AUC requesting that, for the purposes of Sections 25 and 26 of the Hydro Electric Energy Act, regarding service areas, effective January 1, 2012, CAREA be entitled to serve any new customer in the overlapping CAREA Service Area that wishes to obtain electricity for use on such customer's property; and that the Corporation be restricted to providing electric distribution service in the CAREA Service Area only to a customer in that service area who is not being provided service by CAREA. The Corporation has intervened in the proceeding and management believes that the CAREA application is not supportable at law.

*Note: Additional information concerning FortisAlberta Inc. including the Annual Information Form (AIF) is available on SEDAR at [www.sedar.com](http://www.sedar.com).*