SUBMISSION TO THE

ONTARIO ENERGY BOARD

FROM

CHATHAM-KENT HYDRO INC

(Contributions from Middlesex Power Distribution Corporation and
Bluewater Power Distribution Corporation)

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Chatham-Kent Hydro Inc. (CKH), Middlesex Power Distribution Corporation and Bluewater Power Distribution Corporation (BWP), which will be referred to as the "Companies" in this submission, are pleased to provide the Ontario Energy Board (OEB) this submission on the "Staff Discussion Paper on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors".

Guiding Objectives

The Companies find some inconsistencies in some of the objectives that the Staff Paper is trying to achieve and provide the following comments on those objectives:

2. Predictability and stability

The changes in the capital structure are significant deviations from the current capital structure and it also differs from their experts' reports that the staff have provided in 1998 and 2006. These changes in the capital structure also impacts the earnings of all Local Distribution Corporation (LDCs) and the business planning for them. By making these significant changes it will not promote a predictable and stable energy industry.

3. Promote economic efficiency by providing the appropriate pricing signals and a system of incentives for distributors to maintain an appropriate level of reliability and quality of service

The proposed returns afforded to LDCs in the Staff Paper will create financial difficulties for LDCs in attracting reasonable cost debt which will inevitably impact investment and therefore reduce the service quality that will be provided to customers. In most cases the industries that we serve puts reliability of service ahead of price.

4. Ability to raise the financing necessary to invest in distribution infrastructure to enhance service quality and reliability

The capital structure and the rates of returns allowed will not attract investment in the Ontario Electricity Industry which will impact the service quality and most importantly will impact the smart meter initiative which is a corner stone to the Minister of Energy and the Provincial Government's initiative of making Ontario a "Conservation Culture". The inability or the increased difficulty of LDCs in attaining new investment will be discussed in the Cost of Capital section of this submission.

6. Establishing a common capital structure and incentive framework for all distributors

Having a common capital structure will not assist in consolidation in the electricity distribution sector. The significant changes being proposed will be a deterrent to future consolidation because the changes are so significant that potential transactions cannot be valuated because the risk of regulatory change is so significant. Also with a higher debt ratio and lower returns on equity investors will not want to invest in the Ontario Electricity sector.

Cost of Capital

The Companies have great concerns with the significant changes that are being proposed in the capital structure. These changes will significantly reduce the value of the Companies and will make it very difficult to attract financing to invest in capital for regulatory, safety and service quality requirements.

The Companies will expand on the difficulties with the proposed capital structure with the following;

1. Significant change in value of LDC

The significant change in the capital structure that is being proposed will have a significant change in the value of LDCs. An example of the CKH net income follows;

	Current	**Proposal**
Equity	50%	36%
Rate Base	$50 million	$50 million
ROE %	9%	9%
ROE $	$2.25 million	$1.62 million
Difference		$0.63 million
NPV over 10 years		$3.9 million

The calculation above used 9% for the proposed ROE rather than the proposed 8.36% because CKH wanted to only highlight the reduction in value due to the change in the capital structure.

The value of the LDC will decrease by almost $4 million. This would be a significant impact to the shareholders.

2. Interest Coverage Ratios

The change in capital structure will reduce the interest coverage ratio to at or below 2 times earnings. There will be no room for any volatility in the revenue. A low interest coverage ratio will increase the risk of the Companies. Therefore if financing can be attained it will be at higher rates which will increase the costs for the customers.

3. Interest Coverage Ratios – Union Gas Ltd

Union Gas a large gas utility in Ontario, much larger than any individual electrical LDC in Ontario, requires an interest coverage ratio of greater than 2 to ensure that they meet their debt covenants. In their evidence, (RP-2005-0520, Exhibit E1, Tab 1, Page 5 of 13, line 3 to 4) they state that;

> *"Union considers it necessary to plan for a minimum of 2.2 times coverage ratio under the trust indenture to recognize the potential earnings volatility"*

The Companies will fall below a ratio of 2.2 and therefore will not meet the debt covenants that will allow for borrowings at reasonable rates for our customers.

4. Increased risk for smaller LDCs

The Companies believe that the OEB has already endorsed the notion that smaller LDCs face higher risks and that risk was reflected in the differentiation in capital structure approved for large and small LDCs in the 2000 Rate Handbook. The OEB noted at section 3.3.5 of the Decision with Reasons in file number RP-1999-0034:

> *"As for the argument by Enbridge Consumers that the single risk premium may not adequately compensate the higher risk faced by a smaller electric utility, the Board notes that the differentiation in the capital structure contained in the draft Rate Handbook based on rate base size makes allowance for the perceived differences in risk."*

The Companies further believe that in the absence of evidence establishing that the conclusions underlying the initial Rate Handbook were reached in error the OEB should not alter that direction. OEB staff takes the opposite position; that evidence is necessary to support a position already adopted and approved by the OEB. We suggest that is wrong from a regulatory perspective, it is wrong from a policy perspective, and it has very serious consequences discussed below. Therefore, we submit that this issue must be dealt with as early in the process as possible. If the OEB is prepared to stand-by its previous position on this issue, and we suggest that they should in the absence of any evidence from OEB Staff to the contrary, then LDCs and Intervenors need to know before significant effort is expended on this issue.

If the OEB does not resolve this issue early in the process, then expert evidence and LDC submissions will be forced to deal squarely with the issue of quantifying the increased risk faced by smaller LDCs and how that risk must be reflected in a risk premium on the ROE required for those LDCs. The OEB Staff report asks whether there is a need to include an "incentive for investment" ranging between 50 and 150 bps to reflect the need for all LDCs to raise significant capital. However, the OEB Staff report should also ask whether there is a need to include a "risk premium for size of utility" if the OEB accepts the staff recommendation for a common capital structure for all LDCs regardless of size. We would suggest that evidence will be readily available, if necessary, for risk premiums that differentiate between large and small LDCs perhaps based on the current size threshold approved by the OEB in 2000 Rate Handbook.

The Companies have prepared 5 year Business Plans that have been approved by the Shareholders. These plans were based upon the existing Rate Handbook and the significant change in returns will impact the plans and the future investments by the current shareholders.

5. Natural Resources Gas Ltd – Capital Structure

Natural Resources Gas Ltd (NRG) is a small gas distribution company in Ontario with 6,800 customers. The OEB has approved a capital structure that is different than Union Gas and Enbridge Gas in the past. The difference in capital structure and return is mainly due to the size of NRG compared to the other gas utilities and also their lender had put restrictions on how they could distribute funds.

In 1997 the OEB approved a 50:50 debt to equity ratio. The ratio is the same ratio that is currently approved for all electric LDCs in Ontario with rate base of less than $100 M.

In NRG's most recent rate application in front of the OEB, NRG is proposing a 65:35 debt to equity ratio. However, the return on equity would be 150 basis points higher recognizing the increased risk profile.

In summary, the OEB has recognized that the capital structure should be different based upon a utilities size of rate base and that the one size fits all approach does not apply.

6. Dr Canon's report in 1998

The OEB has approved rates for the electricity LDC sector since 2001 and an important source for setting the capital structure and the returns was the report provided to the OEB from Dr Canon. A few key points from Dr Canon's report that are still relevant today are;

- Page 22, 3.3.3
    - "NRG is a "high risk" gas LDC. However, its business risk profile is not unlike that of the majority of Ontario's MEUs"
- Page 35, chart in the middle of the page
    - High risk LDC with a 50:50 debt to equity ratio should attain a credit rating of BBB (l) to BBB

In summary the Dr Canon report states that;

- NRG is a high risk business that has been recognized by the OEB in the past by approving a different capital structure for them compared to the other two large gas utilities. Therefore the OEB has recognized that the capital structure for the large gas utilities does not fit all cases and that one size does fit all.

- Investment grade which will attract investors is BBB or better. In order for a high risk, small LDC to attain investment grade rating and attract investment they will require a 50:50 debt to equity ratio. A lower equity will push the LDC out of investment grade and therefore they may not attract the required financing or if they do it will be at much higher rates that will be passed onto the customers.

7. Dr. Lazar and Dr Prisman report

Dr Lazar and Dr Prisman have a prepared a report, "Calculating the Cost of Capital for LDCs in Ontario", for the OEB. The updated report does not endorse a one size fits all approach. They recognize that there is a different risk profile for LDCs based upon their size and have therefore recommended a two-tier approach as follow;

Rate Base excluding Working Capital	**Debt**	**Equity**
< $300 million	50%	50%
> $300 million	60%	40%

Therefore the OEB should not accept the proposal for one size fits all on the capital structure.

8. Standard and Poor's – Industry Report Card (Appendix 1)

Standard and Poor's (S&P) issued their Industry Report card on July 27, 2006. Their report provides a few interesting points that should be weighed heavily by the OEB in deciding on the capital structure and how it will affect the LDCs ability to attract investments.

- Page 2, third paragraph
  "Interestingly, the positive outlooks, both existing and pre-existing and newly assigned, are largely owner related, either directly in the case of Union, Westcoast and Chatham-Kent Energy (CK Energy: A-/Positive/-) or indirectly, in the case of OPG"
- Page 2, beginning of last paragraph
  "The outlook for some Ontario-based local distribution companies (LDCs) could be negatively affected if upcoming regulatory decisions by the Ontario Energy Board (OEB) follow certain proposals"

The Utilities would like to point out that S&P only has positive outlooks on a few utilities based of their owners' credit worthiness, not based on the credit worthiness of the utility on their own merit. Therefore the only way to get a positive outlook rating is by having a large and very financially strong owner. Without it you will be at a higher risk and borrowing costs would be higher.

The S&P report also highlights that the proposed capital structure will affect the Ontario LDCs negatively which will impact LDCs in attracting investments and if the LDC can get the investments it will be at higher costs to the customers.

Another interesting point in the report is on Table 1, where a number of LDCs from Ontario are rated. A common theme is it is only the larger LDCs being rated. A question to be asked "Are the smaller LDCs not rated because they are too small and will not be rated as investment grade which is BBB or higher?"

9. BMO Capital Markets August 8, 2006 report (Appendix 2)

BMO capital markets have issued a report, The Coming Winter – OEB Staff Proposals Could Freeze Capital Out of Ontario LDCs, on the proposed capital structure. In the summary section on page 1 there are two key points that the OEB should consider;

- *"we believe that the risk premium is between 500 to 621 basis points"*
- *"we believe that that the 2007 ROE for Ontario's local distribution utilities should be 10.25% and 10.86%"*
- *"If Staff recommendations, particularly those relating to return on equity, are adopted and implemented by the Board, it may indeed be a long, cold winter for utility investors"*

The investment community, the lenders and investors do not recognize that the current proposal will attract investment in LDCs. LDCs will not have investments which is necessary to ensure a safe and reliable system; they also have significant investments to make over the next few years to meet the Government of Ontario's smart meter initiative. It is important for the LDCs to be able to attract the investment to meet the Government's goal. This significant change in the capital structure can jeopardize the attainment of this goal.

10. Equity ratio – Union Gas Ltd Evidence

Union Gas Ltd applied for a change in their capital structure in their most recent rate application, RP-2005-0520. Union Gas had applied for an increase in their equity component from 35% to 40%. Their expert witness provided evidence (Exhibit E2, Tab 1) that based upon the return on equity there should be a corresponding equity ratio that will meet the business risks. The witness recommended a capital structure on page 7, lines 1 to 5;

"*In my opinion, the deemed equity ratio is economically consistent with the evidence on the Company's business risk and 9.63 percent return on equity is in the* *upper half of a range from 40 to 50 percent. The corresponding economically consistent deemed equity ratio at a 8.89 percent return on equity is in the upper half of a range from 46 to 56 percent"*

The expert recommends a much higher equity component for Union Gas, a very large gas utility, that is much higher than the one proposed. The question is, "If a very large LDC should have an equity component of around 50% what should a small or medium size LDC have in equity?"

11. Ministry of Finance

The Utilities believe that the Ministry of Finance should be consulted or encouraged to provide input into this proposal. This is being recommended on two fronts, transfer tax implications and payment-in-lieu (PIL) payments.

- Transfer tax

If the equity portion is changed to 36% the Utilities and other LDCs should move their actual equity to this level. However, if dividends are paid to the shareholders of this magnitude, it may trigger the transfer tax for the following reasons;

- More than 5% of the assets would be removed from the LDC
- The equity would be less than the equity transferred into the LDC at the initial incorporation

If there is a transfer tax impact, the value to the shareholder has decreased much more than the $4 million example above. Therefore it is important the Board review the implications of the transfer tax with the Ministry of Finance.

- PIL payments

The proposed capital structure will significantly reduce the earnings for LDCs and therefore they will pay much less in PILs. Lower PIL payments will further delay the reduction of the stranded debt and will significantly impact the cashflow forecasts of paying down that debt.

12. Recent Purchases of LDCs

Chatham-Kent Energy (CKE) the shareholder of CKH purchased MPDC in June 2005. The purchase transaction was based upon a capital structure and regulatory regime of 50:50 debt to equity ratio. The changes proposed in by the staff significantly reduce the returns of this investment, which not only affect CKE but all other recent purchasers of LDCs.

This is an unfair and unreasonable regulatory change in returns. This significant regulatory change will affect future LDC transactions and will slow the process of amalgamations of LDCs in Ontario, because;

- The number of purchasers will decrease because the regulatory risk is too great and therefore the risk of making a deal is too great.
- If a transaction is made the value will be significantly lower because the regulatory risk is too great.

<u>Incentive Rate Mechanism</u>

The Companies are concerned with one component of the2nd Generation Incentive Regulation Mechanism (IRM) proposal at this time.

1. Productivity Factor

It has been noted that a "one-size fits all" IRM will not lead to fair results for LDCs and, more particularly, will not recognize that some LDCs have very little room to find further efficiencies. The argument put forward by Energy Probe attempts to deal with the latter issue by suggesting an efficiency factor that varies with an LDC's current rates; we suggest that simple approach would be as unfair as the OEB Staff proposal because there may be legitimate reasons for one utility to have higher rates than another. Moreover, what about a utility that has implemented significant efficiencies in the interim (through shared services or by expanding revenue opportunities) would they be overly burdened by having to find a further 1% or 2% efficiency?

All of this discussion highlights the fact that it will be extremely difficult to achieve a fair IRM and, given the fact that this Second Generation has such a short-lived application period, we endorse the position of the Power Worker's Union that an efficiency factor is "superfluous" when the OEB is already looking to impose changes on the cost of capital side of the equation. This position is a reflection of the submission of numerous parties to this proceeding that IRM can not be considered in isolation from the OEB's consideration of capital structure and Return on Equity

Summary

The Companies recommend the following;

- The capital structure would be different based upon the size of rate base
- The return on equity will be higher to better reflect the true business risks of LDCs
- There should not be a productivity factor in the 2nd Generation IIRM

STANDARD & POOR'S

INDUSTRY REPORT CARD

Regulatory Questions, Capital Spending Dominate Canadian Utility Sector

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RatingsDirect Publication Date
July 27, 2006
Comments and ratings reflect available public data as of July 21, 2006.

Commentary/Key Trends

In the past six months, the ratings in the Canadian utility sector continued to reflect stable credit quality despite the interest rate-related lowering of allowed returns for many regulated utilities across Canada. Credit outlooks, a leading indicator of rating trends, show that stable outlooks outnumber negative outlooks and CreditWatch Negative placements by three to one, similar to mid-2005. The sector remains solid investment grade, with all but one issuer rating falling within the 'A' and 'BBB' ratings categories. The number of 'A' and 'A-' rated credits has remained unchanged in the past year. There has been some shuffling, both positive and negative, of ratings within the 'BBB' category related to company-specific developments (see chart 1).

Rating actions in the first half of 2006 again reflect company-specific developments rather than a widespread change in the industry's credit quality. Growth-related M&A activity has been the largest single factor influencing changes in outlooks. The number of rating actions (18) undertaken since Feb. 1, 2006, was about the same as in the previous six-month period (17). The total number of upgrades was higher than the number of downgrades. There were, however, fewer positive outlooks assigned than both negative outlooks and CreditWatch Negative placements. As in the previous reporting period, there were no fallen angels.

Positive ratings actions included two upgrades and the raising of three debt issue ratings. The credit ratings on both TransAlta Corp. and its wholly owned subsidiary TransAlta Utilities Corp. were raised to 'BBB' from 'BBB-' as a result of a stronger financial profile and less aggressive financial policy and growth strategy. The Canadian scale CP rating on Ontario Power Generation Inc. (OPG; BBB+/Positive/—) was raised to 'A-1(Low)' from 'A-2', reflecting a significant improvement in OPG's ability to manage cash flow pressures related to its ongoing operations and government-shareholder directives and to do so in a timely, transparent, and well-documented manner. The long-term debt rating on British Columbia Power Authority (BC Hydro) was raised to 'AA+', reflecting an upgrade on its sole shareholder and debt guarantor, the Province of British Columbia (AA+/Stable/A-1+). The long-term debt rating on Newfoundland and Labrador Hydro was raised to 'A', reflecting an upgrade on its sole shareholder and debt guarantor, the Province of Newfoundland and Labrador (A/Stable/A-1).

A positive outlook was assigned to both Union Gas Ltd. (Union; BBB/Developing/—) and Westcoast Energy Inc. (Westcoast; BBB/Developing/—) in May 2006. Both companies are subsidiaries of Duke Energy Corp (Duke Energy; BBB/Positive/NR). The positive outlook was a result of Duke Energy's planned divestiture of its higher risk energy-trading marketing businesses. Subsequently, both Union and Westcoast were put on developing outlook following Duke Energy's announcement in June 2006 that it intends to separate its gas and electricity businesses. The developing outlook reflects uncertainty as to how the proposed new gas company (that would include Westcoast and Union) will be capitalized and funded effective Jan. 1, 2007.

Interestingly, the positive outlooks, both preexisting and newly assigned, are largely owner-related, either directly in the case of Union, Westcoast, and Chatham Kent Energy (CK Energy; A-/Positive/—) or indirectly, in the case of OPG. The positive outlook on CK Energy is solely a reflection of the positive outlook on its owner and guarantor, the Municipality of Chatham Kent (Chatham Kent; A-/Positive/—). The positive outlook on OPG is largely a result of legislative actions taken by its owner, the Province of Ontario, which are expected to improve the long-term business and financial risk profile of the electricity generator.

Two downgrades and several negative outlooks were assigned since Feb. 1, 2006. After being put on CreditWatch Negative in March 2006, the corporate credit ratings on Emera Inc. and its wholly owned subsidiary Nova Scotia Power Inc. (NSPI) were lowered in June 2006 to 'BBB' from 'BBB+'. The downgrade reflects an expectation that the company's historically weak cash flow metrics will not materially improve in the next several years. The revised outlooks to negative from stable on Algonquin Power Income Fund (BBB+/Negative/—), ENMAX Corp. (A-/Negative/—), Gaz Metro Inc. (A-/Negative/—), Gaz Metro L.P. (A-/Negative/—), and Superior Plus Inc. (BB+/Negative/—) can all be largely attributed to recent acquisitions or increased business risk exposure related to their respective growth strategies.

There is the potential for the ratings on Terasen Inc. (BBB/Watch Neg/—) and Terasen Gas Inc. (BBB/Watch Neg/—) to fall below investment grade. The British ColumbiA-based holding company and its regulated gas utility subsidiary were put on CreditWatch Negative following the proposed buyout of U.S.-based parent Kinder Morgan Inc. (KMI: BBB/Watch Neg/A-2) by its management and a group of investors. The negative CreditWatch listing for KMI is prompted by the investors' plans to noticeably increase KMI's financial leverage to fund the purchase. At KMI, the sharp increase in debt contemplated in the buyout offer would likely lead to a downgrade well into the 'BB' category. The negative CreditWatch listing for Terasen reflects its legal, strategic, and business ties to its owner KMI. As part of the CreditWatch resolution, regulatory directives by the British Columbia Utilities Commission will continue to be evaluated regarding their effectiveness, or lack thereof, in proactively isolating Terasen from potential financial pressures that could be exerted by its ultimate owner.

Looking ahead, in the last half of 2006, focus will be on the outcome of generic regulatory hearings in Ontario, and the ability of electric and gas utilities and independent power producers across Canada to execute significant capital investments, proposed and planned.

Regulatory Developments

The outlook for some Ontario-based local distribution companies (LDCs) could be negatively affected if upcoming regulatory decisions by the Ontario Energy Board (OEB) follow certain proposals. At the same time, the timeliness and transparency of regulatory decisions are expected to improve and reduce related cash flow uncertainty. The outcome of the OEB's ongoing generic cost of capital review will be used in rate determinations for 2007 and beyond and could affect the cash flow strength of local distribution companies (LDCs). Both the allowed returns and the regulatory capital structure of some LDCs in Ontario are under examination. A regulatory decision is expected before year-end. The design of the OEB's second-generation incentive regulation that will determine LDC revenue requirements for the period 2007 to 2009 is also in progress. The inclusion of a proposed productivity factor in annual rate adjustments will likely pressure some utilities' ability to earn their allowed returns. On the other hand, improvements to both regulatory transparency through the use of formulas for annual rate adjustment, and timeliness of decisions through streamlined processes, should serve to reduce regulatory risk somewhat as compared with two or three years ago. The OEB has laid out its regulatory calendar for the approximately 90 LDCs in the province's electricity sector for the next several years.

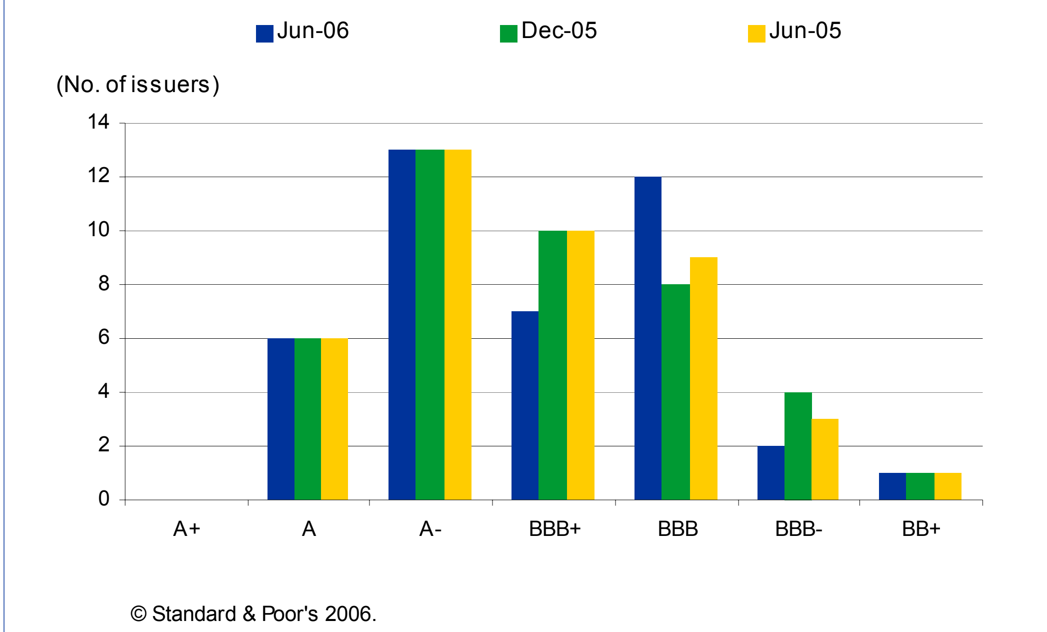
Capital Spending Galore...

An observed trend in all sectors of the industry is increased capital spending that will be predominantly debt financed and much of which will be supported by regulatory frameworks or government backing. There are, of course, the usual financing, regulatory, and operational challenges associated with executing billions of dollars in infrastructure spending that can reduce a company's flexibility and headroom within an assigned rating. In addition, most utilities in North America are exposed to unfavorable staff demographics with a large proportion of the skilled professionals required to execute these capital projects nearing retirement age. Some of the key areas of expansion across Canada are highlighted by sector in the following paragraph.

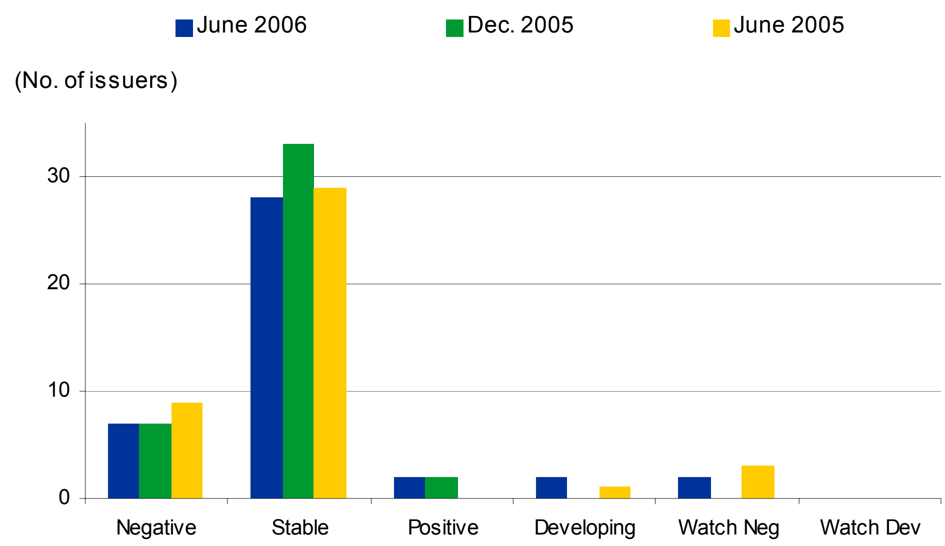
Many transmission owners will significantly increase spending in the near term compared to historical levels to meet growth requirements and maintain reliability. Companies affected include BC Hydro and Fortis BC (a wholly owned subsidiary of Fortis Inc. (BBB+/Stable/—)) in British Columbia, Fortis Alberta (also a wholly owned subsidiary of Fortis Inc.) and CU Inc. (A/Stable/A-1) in Alberta, and Hydro One in Ontario. AlbertA-based AltaLink LP (A-/Stable/—) expects to almost double its rate base in the next five to six years as it copes with major system growth and a new 500 kV line between Edmonton and Calgary (under regulatory review). New transmission infrastructure is proposed in Manitoba and Quebec to bring output from planned generation to market. In New Brunswick, the Crown-owned utility plans to improve reliability of supply through expanded transmission and an additional interconnection with U.S. markets. In generation we see evidence of further new development in Alberta (both coal- and gas-fired), calls for generation proposals by BC Hydro in BC, multibillion dollar nuclear refurbishments planned in Ontario (by OPG and Bruce Power) and in New Brunswick, and significant expansion of Hydro-Quebec's hydroelectric fleet in the next several years. In distribution, many LDCs have reached a stage where they must invest in new infrastructure to be able to accommodate anticipated growth in new connections and increasing energy demand. For some LDCs in Ontario, after taking into account the government-directed investment in smart meters, capital expense may double in the next several years as compared with previous years. Large-scale pipeline and liquefied natural gas projects remain in flux. The financial commitment of individual issuers in any given project is presently uncertain and the timing of the capital spending is not as immediate.

Liquidity across the sector remains generally adequate despite increased working capital requirements. Many companies in the sector have increased both the capacity and tenor of their credit facilities in response to anticipated financing needs and a generally favorable short-term debt environment. There are two factors contributing to increased working capital requirements: increased capital expense beyond annual funds from operations (FFO) generated by most utilities; and, for some companies, higher commodity costs. The regulated returns on existing rate base typically allowed in Canada do not permit utilities to generate sufficient FFO to finance major infrastructure expansion and renewal. Increased bank line capacity has also been necessary as a result of higher commodity prices. Although most utilities affected are supported by regulation that allows for the eventual pass-through of commodity costs to the customer, the settlement process has inherent risks. Based on recent commodity market prices, a midsize LDC's cash requirements, on a monthly basis, can be up to twice the company's annual FFO, highlighting a meaningful, but sometimes forgotten, short-term financial risk that is factored into the ratings of what are typically the smallest companies in the sector.

Canadian Utilities Long-Term Ratings Distribution



Canadian Utilities Outlook Distribution



Issuer Review

Table 1

Canadian Utilities Sector

Electric utilities

Company	Corporate credit rating*	Analyst	Comment
Algonquin Power Income Fund (APIF)	BBB+/Negative/—	Nicole Martin	Algonquin Power Income Fund's first-quarter financial results were in line with expectations. On a rolling 12-month basis, the balance sheet, although still strong, continued to weaken modestly in line with the trend since 2004. APIF's generation assets generated higher funds from operations (FFO) in first-quarter 2006 than in first-quarter 2005 due to higher commodity prices received for both gas and electricity commodity spot sales and above-average hydrology enjoyed by APIF's generation assets in Ontario and Quebec. In line with its growth strategy, APIF announced June 30, 2006, that its takeover bid of AirSource I LP, a 99-MW ManitobA-based wind farm, was successful. A full calendar year's impact of cash flow derived from the wind farm will not be evident until 2007 but is likely to represent close to one-fifth of total cash flow based on the existing portfolio.

Table 1

Canadian Utilities Sector (cont.'d)			
AltaLink, L.P. (AltaLink)	A-/Stable/—	Nicole Martin	In the first half of 2006, there were several regulatory developments related to both AltaLink and its parent AILP (see below), some expected and some unexpected, but all credit neutral. In April, AltaLink filed a tariff application for the calendar years 2007 and 2008 in which it has requested a 14.3% increase in 2007 and a further 8.3% increase in 2008. The request for a significantly higher revenue requirement is founded primarily on expected system growth and the related rate base growth, and true ups of several regulatory deferral accounts. A hearing is scheduled for September 2006. Unexpectedly, in April 2006, the Alberta Energy and Utilities Board (AEUB) announced it would reopen its review of the previously approved western corridor route for the proposed 500-kV transmission line between Edmonton, Alta. and Calgary, Alta., despite, in the regulator's own words, "an adequate hearing process". This decision highlights regulatory risk in Alberta already factored into the rating. The outcome of the hearing, however, is not expected to have any material impact on the rating.
AltaLink Investments, L.P.	BBB-/Stable/—	Nicole Martin	AILP's first-quarter results were as expected. We continue to anticipate a modest improvement to the partnership's weak nonconsolidated key cash flow credit metrics in 2006 as compared with 2005 as a result of the capital restructuring in 2005. Also contributing to a modest reduction in overall financial risk exposure was the establishment of a C$70 million credit facility in June 2006 that significantly improved the partnership's liquidity position. In June 2006, the long-awaited change in ownership, proposed in the fall of 2005, was approved by the AEUB. The change from four unitholders to two, and the presence of a majority owner do not affect Standard & Poor's analytical approach or ratings assessment. Meaningful financial support from the two remaining unitholders and existing ring-fencing measures continue to be factored into the ratings.
ATCO Ltd.	A/Stable/—	Nicole Martin	ATCO's first-quarter results were in line with expectations. The company's CEO recently expressed an interest in developing a 1,680-kilometer electricity transmission line, which would likely cost more than US$1.2 billion. The line would link projected surplus electricity cogeneration close to the oil sands of northern Alberta to the southern Alberta and U.S. electricity markets. Although the potential long-term need for this transmission line has been identified by the Alberta system operator, no application is before the Alberta regulator, who would have to preapprove the line. Financing of the project, should it proceed, is not expected to be an issue because ATCO typically maintains a significant cash balance of more than C$500 million in addition to access to both equity and debt financing. The addition of more regulated wires assets to ATCO's holdings would be unlikely to put pressure on the company's business profile in the long term.

Table 1

Canadian Utilities Sector (cont.'d)			
Borealis Infrastructure Trust's Borealis-Enersource series bonds	A-¶	Nicole Martin	In May the debt rating on the Borealis-Enersource series bonds was affirmed, based on expected continued stability in Enersource's primarily regulated cash flows derived from its MississaugA-based local electricity distribution (LDC) subsidiary. In May 2006, the LDC implemented an estimated 2.3% rate increase, approved by the Ontario Energy Board, and in line with our forecasts. Although Enersource sold its small but high-risk telecommunications business in second-quarter 2006, the utility's strategy, which somewhat weakens the company's otherwise strong business profile, is to continue to engage in competitive-based unregulated businesses (including electricity generation projects). Any move by Enersource to materially increase the size of its unregulated operations as a proportion of its consolidated operations and to aggressively capitalize its unregulated operations would likely increase its risk profile and weaken the rating.
Brookfield Power Inc. (formerly Brascan Power Inc.)	BBB/Stable/A-2	Nicole Martin	The company's financial profile remains weak. Although hydrology improved in first-quarter 2006, commodity prices were lower than expected. In 2005, high electricity commodity prices served to somewhat offset the negative impact of lower-than-average hydrology in some regions. Revenues from Brookfield Power's New York-based assets will enjoy more stability as a result of a new 15-year contract with the Long Island Power Authority (A-/Stable). In the first half of 2006, Brookfield Power completed the acquisition of several small hydroelectric generating facilities, including 38 MW located in Maine for US$144 million and 50 MW located in northern Ontario. The acquisitions are consistent with company plans to expand its generation portfolio. Brookfield Power also completed the sale of 20 MW for C$52.5 million to the Great Lakes Power Income Fund, in which Brookfield Power holds a 50.1% interest.
Canadian Utilities Limited (CU)	A/Stable/A-1	Nicole Martin	The ratings and outlook on Canadian Utilities Ltd. (CU) reflect the ratings and outlook on its major shareholder, ATCO Ltd. As of March 31, 2006, on a trailing 12-month basis, adjusted FFO interest coverage at CU was similar to fourth-quarter 2005. Barring any major transactions, the company's financial profile is expected to remain stable with FFO interest coverage of about 4x expected in 2006. The company continues to maintain a significant cash balance that reached C$939 million as of March 31, 2006. In May 2006 the company announced it would conduct a strategic review of its midstream assets, including exploring a reorganization into a business trust or the potential sale to a third party. CU's portfolio of investments consists primarily of AlbertA-based regulated utility holdings, which contribute the bulk of cash flow from operations, and contracted and merchant power generation. As such, the outcome of the strategic review of the midstream assets is not expected to put pressure on the ratings.

Table 1

Canadian Utilities Sector (cont.'d)			
Caribbean Utilities Co. Ltd. (CUC)	A/Negative/—	Nicole Martin	The recovery of the Cayman Islands' economy after Hurricane Ivan in 2004 continues, in line with company forecasts, with only 350 fewer customers as of fourth-quarter 2006 than those connected just before the hurricane. With the utility connecting more than 100 new customers per month, CUC expects electricity sales to return to 100% of pre-Ivan levels in first-quarter 2007. The company's financial results for fourth-quarter (April 30) fiscal 2006, were in line with Standard & Poor's expectations, bolstered by a gain on the Hurricane Ivan insurance claim settlement of C$1.2 million. License negotiations with the Cayman Islands' government continue. CUC's existing operating license expires in 2011.
Chatham Kent Energy Inc. (CK Energy)	A-/Positive/—	Nicole Martin	The rating and outlook continue to reflect the guarantee of its sole shareholder, the Municipality of Chatham-Kent (A-/Positive/—). Audited 2005 year-end and unaudited first-quarter 2006 results were in line with expectations. The Ontario Energy Board (OEB) approved a 2.5% distribution rate increase as of May 1, 2006, which should provide a mild boost to cash flow from operations and related credit metrics. The impact of a full calendar year of the rate increase will not be evident until 2007. FFO are expected to be approximately C$7 million, sufficient to fund capital expenditures in 2006, including the cost of the installation of government-mandated smart meters.
CU Inc.	A/Stable/A-1	Nicole Martin	The ratings and outlook on CU Inc. reflect the ratings and outlook on its ultimate parent and major shareholder, ATCO Ltd. CU Inc.'s first-quarter results were consistent with expectations and similar to the previous four quarters. The subsidiary's financial profile reflects the Alberta regulatory framework governing its gas and electricity operations. During the first half of 2006 CU Inc. received a decision regarding the regulatory revenue requirement for 2005 and 2006 for its electricity transmission and distribution activities. Somewhat reduced earnings and cash flow in 2006, based on an allowed ROE of 8.93%, although credit negative, are not expected to affect the consolidated ratings on ATCO, CU, and CU Inc. The resulting negative impact on cash flow is not yet evident as the company continued to collect interim, refundable rates in first-quarter 2006 that were set in 2005.
Electricity Distributors Finance (EDFIN) Corp.	A-¶	Nicole Martin	The 2005 financial performance of the three participants in the EDFIN Corp. structure (Barrie Hydro Distribution Inc., EnWin Powerlines Ltd., and PowerStream Inc.) was in line with expectations. The companies will benefit financially from the implementation of distribution rate increases (2.2%, 5.1%, and minus 7.6%, respectively) recently approved by the OEB and effective May 1, 2006. A potential risk to future cash flows for all Ontario LDCs, however, is the outcome of OEB deliberations during calendar year 2006 regarding the allowed cost of capital and the design of second generation incentive-based regulation that will be phased in during 2007 to 2009.

Table 1

Canadian Utilities Sector (cont.'d)			
Emera Inc.	BBB/Stable/—	Nicole Martin	Emera's first-quarter results reflected NSPI's significantly increased fuel expense partially offset by a regulated rate increase approved in 2005. The results also reflected cash flow generated from the resale of gas under contract and not required for electricity generation, the result of a prolonged strike at one of the utility's major industrial customers. In March 2006, the utility received approval for a further rate increase to cover additional fuel expense in 2006. The current ratings are premised on a marginal improvement, as compared with 2005, in the company's financial profile, with expected FFO interest coverage of 3.2x and FFO-to-average total debt of 16% in 2006. After announcing plans to develop a debt- and equity-financed US$300 million gas pipeline that will serve Repsol YPF (BBB/Stable/A-2) out of Repsol's proposed Canaport LNG terminal, Emera remained on track to meet expectations in 2006. Construction on the pipeline is not expected to begin until 2007 or later.
ENMAX Corp.	A-/Negative/—	Nicole Martin	Although its consolidated balance sheet remains strong on an unadjusted basis, in first-quarter 2006, ENMAX's total debt increased to C$348 million as of March 31, 2006, from C$204 million as of Dec. 31, 2005. The company obtained C$154 million in debt financing through its owner, the City of Calgary (AA+/Stable/A-1+), to finance its regulated utility capital expenditures. ENMAX subsequently purchased the Battle River PPA from EPCOR Utilities Inc (BBB+/Stable/—) in May 2006 for C$500 million. ENMAX financed the C$367 million 2006 installment of the purchase largely with cash on hand, available as a result of the earlier debt issuance, and short-term investments. The remaining four C$50 million payments in each of the next four years are not onerous. Because there was no positive cash flow impact in the first quarter related to the purchase and because debt levels almost doubled, the utility's first-quarter key credit metrics suffered accordingly. Although a modest decline in financial strength is expected in 2006, if management takes on additional, material debt-financed energy supply commitments or assets, or is unable to live up to forecast cash flow growth from ENMAX's marketing activities in the next year, a downgrade is possible.
EPCOR Power L.P. (EPCOR Power)	A-/Stable/—	Nicole Martin	EPCOR Power's financial results for first-quarter 2006 were largely in line with Standard & Poor's expectations, boosted by higher revenue at its Curtis Palmer hydroelectric plant due to favorable hydrology in the quarter; and by a one-time settlement payment with the Ontario Electricity Financial Corp. of C$8.5 million. Despite the positive first-quarter results and modest cash flow accretion related to the Fredrickson plant acquisition (expected to close in July 2006), cash flow interest and debt coverages in 2006 are not expected to meet 2005 performance. The partnership is, however, expected to maintain a moderate level of debt (35%-40% of total capitalization) and continue to demonstrate strong, although somewhat reduced from 2005, cash flow protection with minimum FFO interest coverage of about 5.5x and FFO-to-average total debt of about 27% in 2006.

Table 1

Canadian Utilities Sector (cont.'d)

EPCOR Utilities Inc. (EPCOR Utilities)	BBB+/Stable/—	Nicole Martin	EPCOR Utilities' financial results for first-quarter 2005 were in line with Standard & Poor's expectations. Furthermore, consistent with its strategy to realign its business, EPCOR Utilities continues to develop its commercial generation operations and to focus its competitive energy retail business on a smaller number of higher value customers. The company announced March 15, 2006, that it has signed an agreement to jointly pursue the development of the Keephills 3 power project with TransAlta Corp. (BBB/Stable/—). The Keephills 3 project is a proposed 450-MW coal-fired power generation plant located 70 kilometers west of Edmonton, Alta. Should the project go ahead, it would be unlikely to come online before 2010. EPCOR Utilities closed the sale of its ownership position in the Battle River Alberta PPA to ENMAX Corp. in late May 2006. In second-quarter 2006, in keeping with its generation-focused growth strategy, the company announced its plans to install three 100-MW natural gas-fired turbines at its preexisting Clover Bar site during 2007 to 2010.
Fortis Inc.	BBB+/Stable/—	Bhavini Patel	Fortis' first-quarter results were in line with expectations. Recent regulatory developments have been moderately positive for several of the holding company's regulated utility subsidiaries. During first quarter, following the review of the current ROE mechanism applicable to utilities in British Columbia, the BC Utilities Commission issued an order approving adjustments to the mechanism that increased the 2005 ROE for subsidiary Fortis BC to 9.20% from 8.69%. The company's AlbertA-based regulated network business, Fortis Alberta, received regulatory approval for a rate increase in late June. The increase was based on a negotiated settlement with an allowed 8.9% ROE, consistent with Alberta's generic cost-of-capital formula, and no significant cost reductions imposed by the regulator.
Hamilton Utilities Corp. (HUC)	A/Stable/—	Nicole Martin	A 2.6% average rate decrease was approved by the OEB in first-quarter 2006 and implemented by Horizon Utilities, a subsidiary of HUC, in its distribution rates effective May 1, 2006. The OEB rate decision is consistent with an allowed 9% ROE, lower than the previously allowed 9.88%, on a deemed capital structure that includes 40% equity. Although not sufficient to compromise the rating or outlook, the lower allowed ROE in 2006 will have a negative impact on cash flow. This regulatory determination removes an element of uncertainty surrounding HUC's 2006 cash flows, but the impact of an ongoing review of the cost-of-capital and the design of performance-based regulation for 2007 and beyond by the OEB remains unknown. The company's first-quarter results are largely in line with expectations. We expect HUC to continue to achieve modest cost savings from the merger of Hamilton Utilities and St. Catharines Hydro and to evaluate further merger opportunities. As per OEB regulation, the utility is expected to begin the government-directed installation of smart meters for all its customers in the last quarter of 2006. Annual FFO is estimated to be C$40 million for the next two years, which will adequately cover capital expenditures and smart meter expenses.

Table 1

Canadian Utilities Sector (cont.'d)

Hydro One Inc.	A/Stable/A-1	Nicole Martin	Regulatory determinations in first-quarter 2006 were generally neutral-to-favorable for credit quality, with the effect on Hydro One's financial profile in line with our expectations. The company's transmission rates in 2006 will remain largely unchanged from those applicable in 2005. The decision on the utility's 2006 distribution revenue requirement and rates included no surprises, with the utility for the most part receiving what it had applied for. Notably, the determination, the first since 1999, establishes a more up-to-date cost platform for future regulatory determinations. A potential risk to future cash flows for all Ontario LDCs, however, is the outcome of OEB deliberations during calendar year 2006 regarding the allowed cost-of-capital and the design of a second generation incentive-based distribution regulation that will implemented during 2007 to 2009. Hydro One's distribution operations currently represent about 40% of annual cash flow. Hydro One's consolidated financial results for first-quarter 2006 were in line with Standard & Poor's expectations and consistent with performance of the past four quarters, evidence of the company's relatively stable financial profile and low-risk business profile.
Hydro Ottawa Holding Inc. (HOHI)	A-/Stable/—	Nicole Martin	Although not a rating concern, HOHI's key credit metrics at the end of first-quarter 2006 were slightly lower than in the previous quarter, given the mild winter that somewhat reduced volumes of electricity delivered. Several new executives have joined the company, with both the CEO and CFO roles now filled on a permanent basis. No material change in the company's strategy or consolidated business and financial risk profiles is anticipated in the near term. In April 2006, the OEB approved an average 2.9% increase in the company's regulated distribution subsidiary's residential electricity rates that was implemented May 1, 2006. The majority of issues raised during the regulatory review were resolved through a settlement process. The rate increase reflects a revenue requirement of about C$122 million that is slightly lower than the C$125 million applied for by the utility. The revenue requirement includes an allowed 9% return on a 40% deemed equity layer, in keeping with other Ontario LDCs but lower than the 9.88% return previously allowed.
London Hydro Inc. (LHI)	A-/Stable/—	Nicole Martin	As anticipated, a 4.1% rate increase requested by the company was approved by the OEB and implemented May 1, 2006. The rate increase will provide a mild boost in cash flow from operations and related credit metrics in 2006. The impact of a full calendar year of the rate increase, however, will not be evident until 2007. Regulatory approval to recoup the bulk of the utility's deferred costs incurred before 2004 continues to enhance LHI's cash position. Our expectation that the company will face significant capital outlay in the next few years remains unchanged. LHI will spend an estimated C$50 million on the provincially directed smart meter initiative over the course of the next few years. All currently anticipated capital spending will serve to increase the company's regulated rate base and eventually contribute to earnings.

Table 1

Canadian Utilities Sector (cont.'d)			
Maritime Electric Co. Ltd.	BBB+/Stable/—	Nicole Martin	The ratings and outlook on Maritime Electric reflect the ratings on its sole shareholder, Fortis Inc., a Newfoundland-based utility holding company. Despite a modest rate increase being approved in July 2006, there is no change to our expectation of minimal improvement in Maritime Electric's modest cash flow coverage in 2006. Debt servicing costs at the Prince Edward Island-based utility are expected to increase in 2006 due to the partial debt funding of a higher-than-normal capital expenditure program. Cash flow credit metrics are expected to return in 2007 to sustainable levels similar to those realized in 2004.
Newfoundland Power Inc.	BBB+/Stable/—	Bhavini Patel	The ratings and outlook on Newfoundland Power reflect the ratings on its sole shareholder, Fortis Inc. Effective Jan. 1, 2006, Newfoundland Power changed its revenue recognition policy to an accrual basis (from a billed basis). As a result, earnings in the first and second quarters will be reduced compared with the same quarters in 2005, and earnings in the third and fourth quarters will increase, in total, by the same amount. There is no rating impact. The regulator is expected to keep the company whole with regards to any related cost recovery issues. The company's first-quarter results were in line with expectations.
Nova Scotia Power Inc. (NSPI)	BBB/Stable/—	Nicole Martin	The ratings and outlook on NSPI reflect the ratings and outlook on its sole shareholder, Emera. On a rolling 12-month basis, first-quarter results were slightly better than fourth-quarter 2005 but not quite as strong as first-quarter 2005, and were in line with expectations. In March 2006 after applying for a 15% rate increase to cover increased fuel costs, NSPI received regulatory approval for an 8.9% rate increase effective April 2006. The utility is expected to file an application for a 2007 rate increase this year.
Ontario Power Generation Inc. (OPG)	BBB+/Positive/A-2	Nicole Martin	First-quarter 2006 results continued to demonstrate the complete turnaround in OPG's financial outlook since first-quarter 2005, largely due to the new regulatory regime and pricing scheme now enjoyed by OPG. Furthermore, despite lower-than-average electricity demand in Ontario caused by a warmer-than-normal winter, OPG's electricity production was only marginally lower than in the first quarter of 2005, as the bulk of OPG's competitive production output is base- and intermediate-load. Barring any negative regulatory or political action, if the company's improved operational and financial performance continues as forecast in 2006 and the outlook for 2007 and beyond remains unchanged, the company is on track for a positive rating action within the next 12 months.

Table 1

Canadian Utilities Sector (cont.'d)			
Toronto Hydro Corp.	A-/Stable/—	Nicole Martin	Despite a mild winter, Toronto Hydro's first-quarter results were in line with expectations. As Toronto Hydro continues to unwind its electricity retail operations in 2006 and the first half of 2007, consolidated financial results will continue to benefit from cash flow derived from matched retail and supply contracts previously in place. In the next three years, the utility also expects to recover about C$20 million per year in deferred regulatory assets. In its April 2006 decision, the OEB approved a 9.5% rate decrease requested by the utility that will be effective May 1, 2006. The reduced tariff, based on a C$53 million decrease in the company's deemed annual revenue requirement, will not affect results until second-quarter 2006. In determining the revenue requirement, the OEB allowed only 5% interest on borrowings from a related party. The holding company is discussing the terms and conditions of the C$980 million promissory note held by its owner, the City of Toronto, including the current interest rate of 6.8%.
TransAlta Corp.	BBB/Stable/—	Nicole Martin	TransAlta's stronger financial profile as a result of stronger cash flows and lower debt, and the company's less aggressive growth strategy contributed to an upgrade in February. Plant availability was marginally improved in the first half of 2006 as compared with the same period last year. Management has been focused on managing coal fuel inventory at the U.S.-based Centralia facility that has been constrained by weather-related operational issues and delays in acquiring mining permits. The negative impact of related increased operating and fuel expense on cash flow has been offset by higher electricity prices; the generator's financial profile on a rolling 12-month basis continues to improve as expected. The Ontario Power Authority signed a five-year agreement with TransAlta in February 2006 to purchase power from the company's Sarnia gas-fired merchant facility in Ontario. The company announced in March that it was jointly pursuing, with EPCOR Utilities Inc., a proposal to develop a new 450-MW coal-fired unit at its Keephills facility.
TransAlta Utilities Corp. (TAU)	BBB/Stable/—	Nicole Martin	The ratings on Calgary, Alta.-based TAU reflect the 'BBB' rating on its sole shareholder, TransAlta Corp. TAU's financial and operational performance as of June 30, 2006, was in line with expectations. Below-average hydrology and increased operating and fuel costs were offset by higher market prices in first-quarter 2006 as compared with the previous year. Intercompany preferred securities issued in June 2006 do not affect the ratings on TAU or its parent.
Utilities with provincial debt guarantees			
British Columbia Hydro & Power Authority (BC Hydro)	AA+§	Nicole Martin	The rating on BC Hydro's senior unsecured debt is based on the timely debt service guarantee provided by the utility's owner, the Province of British Columbia (AA+/Stable/A-1+). Fiscal third-quarter results, as of Dec. 31, 2005 were, on a rolling 12-month basis, marginally better than the previous quarter, in line with expectations. BC Hydro's weak financial profile is subject to some variation related to hydrology conditions and electricity commodity prices in the U.S., both of which were in the utility's favor. BC Hydro needs to upgrade its generation and transmission infrastructure to meet growing electricity demand in the province. In recognition of this need, the British Columbia Utilities Commission approved a 4.65% interim increase to BC Hydro's rates effective July 1, 2006. A rate hearing is anticipated in fall 2006 with a final rate decision likely in early 2007.

Table 1

Canadian Utilities Sector (cont.'d)			
Hydro-Quebec	A+§; A-1+§	Nicole Martin	The ratings on Hydro-Québec's senior unsecured long- and short-term debt are based on the timely debt service guarantee provided by the utility's owner, the Province of Québec (A+/Stable/A-1+). Total debt outstanding as of March 31, 2006, was about C$35 billion. FFO interest coverage improved marginally to 2.6x at year-end 2005, as compared with 2.5x in 2004. In February 2006, the regulator approved an average 5.3% electricity rate increase for the 2006-2007 rate year, reflecting increased energy costs. Electricity demand is growing faster than expected in the province, with new sources of electricity supply, over and above the utility's 165 terawatt-hours in the heritage pool priced at C$27.90 per MWh, costing an average of C$105 per MWh in 2006. Starting in 2007, the company's operating margins may be negatively affected by a recent government decision to collect water royalties from its wholly owned utility. This may also result in a modest reduction in forecast FFO and slightly higher-than-expected borrowing requirements to fund planned growth in Hydro-Quebec's hydroelectric generation asset base in the next several years.
Manitoba Hydro-Electric Board (Manitoba Hydro)	A-1+§	Nicole Martin	The rating on Manitoba Hydro's CP is based on the timely debt service guarantee provided by the Province of Manitoba (AA-/Stable/A-1+). Above-average water flow conditions continue to allow above-average exports to U.S. markets in third fiscal quarter ending Dec. 31, 2005. In June 2006, the government-owned utility signed an agreement with the Nisichawayasihk Cree Nation to develop a 200-MW hydroelectric facility at Wuskwatim, in northern Manitoba. Licenses for both the generating station and related transmission investment have been issued. Construction on access roads will begin this summer with the C$1 billion project expected to be in service by 2012.
New Brunswick Electric Finance Corp. (NBEFC)	AA-§	Nicole Martin	The rating on the C$125 million senior unsecured, provincially guaranteed debt, originally issued by the former New Brunswick Power Corp. (NB Power), and now an obligation of NBEFC, continues to reflect the debt service guarantee of the Province of New Brunswick (AA-/Stable/A-1+). Cash flow from operations from NBEFC's wholly owned New Brunswick Power group of companies (Group) supports all the debt obligations at NBEFC. NB Power Distribution and Customer Service Corp. (part of the Group) submitted a rate application to the New Brunswick regulator for an overall average 11.6% rate increase as of April 1, 2006. The requested rate increase was rationalized by an estimated C$127 million revenue shortfall anticipated in fiscal year 2006-2007 due to rising fossil fuel costs should rates remain flat. In a move that does not bode well for regulatory independence in the province's electricity sector, the provincial government preempted the outcome of an upcoming regulatory decision. The government announced in March 2006 that it would cap residential electricity rate increases at 8% and subsidize customers by providing a rebate on energy, equivalent to the 8% provincial sales tax. On June 19, 2006, the regulator approved rates that it believed would result in no more than an average 10% increase to residential bills. On June 30, 2006, the province confirmed its previously announced rate cap and rebate program. On a more positive note for the utility, the Canadian Nuclear Safety Commission announced June 30, 2006, that the Point Lepreau Generating Station's Nuclear Power Reactor operating license had been renewed and would be valid until June 30, 2011.

Table 1

Canadian Utilities Sector (cont.'d)			
Newfoundland and Labrador Hydro (NLH)	A§; A-1§	Nicole Martin	The ratings on Newfoundland and Labrador Hydro's short- and long-term debt reflect the timely debt guarantee provided by the integrated utility's sole shareholder, the Province of Newfoundland and Labrador (A/Stable/A-1). The utility's 2005 year-end results were in line with Standard & Poor's expectations. NLH's weak financial position was expected to, and did, improve marginally in 2005 (and further in first-quarter 2006) as compared with 2004. The improvement was largely a result of an improved regulated rate stabilization plan (RSP) that significantly reduced fuel-cost recovery risk by the introduction of a fuel rider mechanism in 2004. In keeping with the RSP, the regulator approved a 4.8% rate increase effective July 1, 2006, largely to account for the higher-than-previously forecast cost per barrel of oil used to fuel the utility's Holyrood generating station. In May 2006 the provincial government, after examining several third-party proposals, announced that NLH will lead the development of the Lower Churchill Falls hydro resource and determine the project's financial, technical, and environmental feasibility. Various options for the configuration of the proposed 2,824 MW Labrador-based hydroelectric project, related transmission, and potential markets for its output are under review. At the same time, the province has not eliminated the potential involvement of third-party developers and investors. Estimates of the earliest in-service date for the multibillion dollar project, should it proceed, generally point to 2015 or later.
Gas distribution utilities and pipelines			
AltaGas Income Trust (AIT)	BBB-/Stable/—	Bhavini Patel	Utilization rates at the Field Gathering and Processing facilities were low, but are expected to improve as new start-up facilities begin operating at normal levels and volumes ramp up at some of the existing facilities that experienced planned and unplanned downtime. Higher frac spreads in the Extraction and Transmission segment resulted in higher operating income, despite lower volumes produced and transported. Due to the contractual arrangements in place, there was minimal impact on AIT's financial results in spite of lower volumes. In addition to strong operating margins achieved in its Power Generation segment, in the first quarter of 2006, AIT realized additional cash flow contributions from earlier expansions and acquisitions made in the Field Gathering and Processing segment in late 2005. AIT's credit metrics were also bolstered by a reduction in interest expense as proceeds from the Natural Gas Distribution segment spin-off in November 2005 were used for debt repayment.
Enbridge Inc. and rated subsidiaries	A-/Stable/—	Michelle Dathorne	The company's first-quarter 2006 results continue to highlight the stability of its credit metrics, with FFO interest and debt coverages and leverage not too dissimilar to those at year-end 2005. Stability of the company's financial profile is critical to maintaining the ratings, given the company's move over time to expand its scope of operations into areas with greater business risk than that associated with its core liquids transportation and gas distribution operations. The ratings incorporate an expectation of continued expansion in the company's operations primarily through organic growth opportunities, supplemented at times by modest asset or business acquisitions. More particularly, Enbridge is expected to leverage its strong business position as the dominant liquids pipeline owner and operator in Canada by meeting the rising needs of oil sands producers for increased pipeline capacity for export to the U.S. and offshore. A looming issue for the ratings is Enbridge's need to finance an estimated C$8 billion in organic growth opportunities earmarked in the next four to five years. To support its funding needs, the company established C$3.5 billion of debt shelf programs at Enbridge and its wholly owned affiliates in late 2005 and early 2006.

Table 1

Canadian Utilities Sector (cont.'d)			
Fort Chicago Energy Partners, L.P. (Fort Chicago)	BBB/Stable/—	Bhavini Patel	Fort Chicago's first-quarter results were negatively affected by an appreciation of the Canadian dollar, a decline in the Alliance investment rate base, and the absence of any recognition of year-to-date net margin fee as per Aux Sable's NGL sales agreement with BP. Pipeline deliveries at Alliance averaged 26.8% excess of firm capacity (at about 1.7 thousand cubic feet per day), and toll volumes on the Alberta Ethane Gathering system increased 2.3% to 320.7 thousand barrels per day in the first quarter. In the next quarter, financial performance at Aux Sable is expected to be bolstered by strong natural gas liquids (NGL) prices that are supported by lower natural gas prices, relatively higher oil prices, and a strong demand for NGLs.
Gaz Metro, Inc. (GMI) and Gaz Metro Limited Partnership (GMLP)	A-/Negative/—	Bhavini Patel	As expected, in the first half of fiscal 2006, a warmer heating season, high gas prices, and lower allowed returns linked to lower borrowing rates on Canadian long-term bonds, have resulted in a decrease in profitability in GMI's core Quebec natural gas distribution business segment. The partnership's announcement in June 2006 to acquire Green Mountain Power (GMP; BBB/Watch Positive/—) is in line with GMI's expanded growth strategy. The gas distribution company intends to diversify its operations and become an integrated energy provider.
Inter Pipeline Fund (IPF)	BBB/Stable/—	Bhavini Patel	The addition of the European storage business in late 2005 and early 2006, favorable natural gas liquids (NGLs) margins for propane-plus volumes produced at the Cochrane plant, and mainline toll increases within the conventional oil pipeline business segment have contributed to IPF's improved financial performance in the first quarter. From an operational perspective, recent expansions of the Bow River system and improved weather conditions have resulted in an increase in average volumes transported through the conventional system. Recent financial results are consistent with the stable outlook that also reflects an expectation that the partnership's business risk profile will remain relatively unchanged in the next two years.
Pembina Pipeline Corp.	BBB/Stable/—	Bhavini Patel	As was expected, volumes on Pembina's conventional systems continued to experience modest growth in the first quarter of 2006. This trend is expected to continue in the near term as Pembina continues to add new connections and complete facility upgrades. Higher revenues from the company's Alberta systems were in part due to recent tariff increases. Increased revenues on the British Columbia systems were attributable to higher volumes. The oil sands infrastructure projects announced last year are also proceeding as expected. The company placed an order for C$50 million of pipe in anticipation of commencing production on the Horizon Pipeline. Subsequent to first quarter, Pembina announced it had entered into an agreement with institutional investors for the private placement of C$200 million of senior unsecured notes, with closing expected Sept. 30, 2006. The funds will be used to partially finance the company's infrastructure projects.

Table 1

Canadian Utilities Sector (cont.'d)			
Superior Plus Inc. (Superior)	BB+/Negative/—	Bhavini Patel	First-quarter results for Superior were negatively affected by several challenges faced by the propane distribution and specialty chemicals businesses. Unseasonably warm weather and customer conservation in response to an increase in average wholesale propane costs resulted in lower-than-expected cash flow from operations. Furthermore, closures of several North American pulp mills in the last year as a result of high energy and fiber costs and a rising Canadian dollar have softened demand for ERCO Worldwide's sodium chlorate business. A negative rating action is possible if Superior is unable to improve its financial profile. On July 10, 2006, as a result of its strategic review, Superior announced its intention to dispose of its interest in JW Aluminum, rationalize the specialty chemicals business and reduce debt levels and partially offset poor operating performance in the propane and specialty chemicals business and improve its financial profile. A material loss on the disposition will put further pressure on the company's already weakened credit metrics.
Terasen Gas Inc.	BBB/Watch Neg/—	Bhavini Patel	Terasen Gas is a British ColumbiA-based, regulated gas distribution subsidiary of Terasen Inc. The creditworthiness of the company mirrors that of Terasen Gas' ultimate parent, U.S.-based Kinder Morgan Inc. (KMI; BBB/Watch Neg/A-2).
Terasen Inc.	BBB/Watch Neg /—	Bhavini Patel	In line with Standard & Poor's consolidated ratings methodology, the ratings on Terasen Inc. reflect the consolidated credit profile of its ultimate parent, KMI. Terasen Inc.'s first-quarter results were in line with expectations. Favorable economic conditions and housing activity in British Columbia continue to drive solid customer growth in that region. On a year-over-year basis, earnings from the petroleum transportation business increased as a result of higher throughput in the TransMountain system and higher earnings from the Express system as a result of completion of the Express expansion project.
Trans Quebec & Maritimes Pipelines Inc. (TQM)	BBB+/Stable/—	Bhavini Patel	TQM continues to benefit from the stable market demand for natural gas in its primary Canadian market, Quebec. Despite a mild winter in Quebec, first-quarter performance was not negatively affected, largely due to TQM's transportation agreement with TransCanada Pipeline Ltd., which results in revenues independent of volumes. The pipeline is well positioned, through its link with the Portland Natural Gas Transmission System, to supply growing markets in the northeast U.S. Although several proposed LNG terminals in Quebec are moving forward with environmental and regulatory approvals, they are not expected in service for the next two years. The terminals could bring incremental volumes in the medium term; volumes from these projects would come with a risk in the consistency of supply. This risk could be mitigated with long-term take-or-pay contracts with solid counterparties.

Table 1

Canadian Utilities Sector (cont.'d)			
TransCanada PipeLines Ltd. and NOVA Gas Transmission Ltd.	A-/Negative/—	Michelle Dathorne	With recent decisions from the NEB, the deemed equity layers attributed to the B.C. System and Foothills pipelines have been aligned with that of the Mainline at 36%. Although the equity layers for TransCanada's wholly owned Canadian pipelines have increased by about 6%, earnings remain adversely affected by the decreasing returns calculated under the existing formula, and a diminishing rate base. The natural gas pipeline portfolio remains challenged by falling returns and competition from other transportation systems serving other supply basins, but TransCanada's proposed Keystone crude oil pipeline should provide attractive long-term financial performance, given its link to Canada's rapidly developing oil sands resources. TransCanada's power portfolio continues to generate strong cash flows, and although capacity under long-term contracts in the western segment fell as new generation capacity was added at the beginning of 2006, we expect TransCanada will continue to manage its power portfolio's price volatility by selling forward the majority of its generated electricity. The benefits of recent acquisitions continue to accrue to the company, and at year-end 2005, annual FFO increased 14.6% year-over-year.
Union Gas Ltd.	BBB/Developing/—	Bhavini Patel	The ratings on Union Gas reflect the consolidated credit profile of parent Duke Energy Corp. (BBB/Positive/—). The ratings on Duke Energy were affirmed after news of the company's decision to separate its gas and electricity assets. The new gas company will consist of the CanadA-based subsidiaries Westcoast Energy Inc. and Union Gas Ltd.; all of Duke Energy's U.S. transmission assets and a 50% ownership interest in Duke Energy Field Services. Although the outlook on Duke Energy remains positive, uncertainty regarding the eventual capitalization and funding of the new gas company supports the developing outlook on Duke Capital and its rated gas subsidiaries. Please see the Research Update on Duke Energy Corp. published June 29, 2006, on Ratings Direct, Standard & Poor's Web-based credit research and analysis system.
Westcoast Energy Inc.	BBB/Developing/—	Bhavini Patel	The ratings on Westcoast Energy reflect the consolidated credit profile of parent Duke Energy The ratings on Duke Energy were affirmed after news of the company's decision to separate its gas and electricity assets. Please see June 29, 2006, Research Update on Duke Energy.

*Ratings are as of July 21, 2006. ¶Debt rating. §Guaranteed debt rating.

Quarterly Rating Activity

Table 2

Rating/Outlook/CreditWatch Actions				
Issuer	**To**	**From**	**Date***	**Reason**
Algonquin Power Income Fund	BBB+/Negative/—	BBB+/Stable/—	June 8, 2006	The outlook revision reflects the view that generating sufficient FFO to fully fund distributions will remain a challenge, given fund's acquisitive growth strategy, the operational performance of APIF's alternative fuels and cogeneration assets, and exposure to hydrology and wind risk.
British Columbia Hydro & Power Authority (BC Hydro)	AA+*	AA*	June 8, 2006	The long-term debt rating on BC Hydro reflects the guarantee provided by the utility's sole shareholder, the Province of British Columbia (British Columbia: AA+/Stable/A-1+). The ratings on the province were raised to 'AA+' from 'AA' on solid financials. British Columbia's net tax-supported debt burden is expected to remain relatively stable in the next three fiscal years and then trend slowly downward. Furthermore, the province is expected to post annual operating surpluses in each of the next three fiscal years. Strong fiscal management and significantly improved transparency in the province's budgetary planning and reporting also contributed to the provincial upgrade.
Emera Inc.	BBB/Stable/—	BBB+/Watch Neg/—	June 21, 2006	The consolidated ratings on Emera and its wholly owned subsidiary NSPI were removed from CreditWatch Negative and lowered, reflecting a expectation that the company's historically weak cash flow metrics will not materially improve in the next several years given no assurance of full recovery of fuel-related expense under the current regulatory framework for its utility subsidiary NSPI that is Emera's key source of cash flow generation; an evolving fuel procurement strategy at NSPI; and upcoming challenges related to the approval, financing, and execution of several proposed capital projects at Emera, NSPI, and Emera's small U.S.-based regulated utility subsidiary Bangor Hydro.
ENMAX Corp.	A-/Negative/—	A-/Stable/—	May 10, 2006	The ratings were placed on CreditWatch pending Standard & Poor's review of the long-term credit implications of ENMAX's purchase of the Battle River Power Purchase Arrangement (PPA) from EPCOR Utilities Inc. (BBB+/Stable/—) for C$567 million. On May 10, 2006, the ratings were affirmed with a negative outlook given the company's plans for significant growth in its unregulated businesses and related less certain cash flow. Standard & Poor's expectation of an upcoming period of wholesale and retail electricity market uncertainty and the potential for related volatility in Alberta also contributed to the revised outlook.
Gaz Metro Inc (GMi) & Gaz Metro Limited Partnership (GMLP)	A-/Negative/—	A-/Stable/—	June 22, 2006	On June 22, 2006, a wholly owned subsidiary of GMi, Northern New England Energy Corp., announced its intention to acquire Green Mountain Power (GMP: BBB/Watch Positive/—), a public electric utility based in Vermont. The acquisition is in line with GMi's recently expanded growth strategy.

Table 2

Rating/Outlook/CreditWatch Actions (cont.'d)				
Issuer	***To***	***From***	***Date****	***Reason***
Newfoundland and Labrador Hydro	A*	A-*	July 19, 2006	The short- and long-term debt ratings on Newfoundland and Labrador Hydro reflect the timely debt guarantee provided by the integrated utility's sole shareholder, the Province of Newfoundland and Labrador. The long-term issuer credit and senior unsecured debt ratings on the Province of Newfoundland and Labrador were raised to 'A' from 'A-', reflecting substantial improvement in the province's overall budgetary performance in the past two fiscal years. The improvement in the province's economy in recent years has been driven by gains in offshore oil production and strong domestic demand.
Nova Scotia Power Inc. (NSPI)	BBB/Stable/—	BBB+/Watch Neg/—	June 21, 2006	The ratings on NSPI reflect the consolidated business and financial risk profile of its parent, Emera Inc. (BBB/Stable/—), based on Standard & Poor's consolidated rating methodology. (Please see Emera Inc.)
Oakville Hydro Corp.	NR	BBB+/Stable/—	Feb. 8, 2006	The rating was withdrawn at the company's request.
Ontario Power Generation	A-1(Low)¶	A-2*¶	May 25, 2006	The upgrade was a reflection of a significant improvement in OPG's ability to manage cash flow pressures related to its ongoing operations and government-shareholder directives and to do so in a timely, transparent, and well-documented manner
Superior Plus Inc.	BB+/Negative/—	BB+/Stable/—	April 25, 2006	The outlook revision followed Superior's announcement that it was initiating a comprehensive strategic review of its portfolio of diverse businesses. A significant divesture of any business line as a result of the company's strategic review could pressure the ratings.
Terasen Gas Inc.	BBB/Watch Neg/—	BBB/Negative/—	May 30, 2006	Refer to Terasen Inc.
Terasen Inc.	BBB/Watch Neg/—	BBB/Negative/—	May 30, 2006	The ratings on KMI and its subsidiaries were placed on CreditWatch Negative following the announced offer by a group of KMI management and private investors to buy all of KMI's common shares outstanding. The CreditWatch is prompted by the investor group's plans to further increase KMI's consolidated financial leverage to fund the purchase.
TransAlta Corp.	BBB/Stable/—	BBB-/Stable/—	Feb. 6, 2006	The upgrade was a reflection of TransAlta's stronger financial profile, less aggressive financial policy and growth strategy, and no meaningful change in the company's business risk profile expected in the next several years.
TransAlta Utilities Corp.	BBB/Stable/—	BBB-/Stable/—	Feb. 6, 2006	The ratings on TransAlta Utilities reflect the consolidated business and financial risk profile of its parent, TransAlta Corp. Please see TransAlta Corp.
Union Gas Ltd.	BBB/Positive/—	BBB/Stable/—	25-May-06	Please see Westcoast Energy Inc.
Union Gas Ltd.	BBB/Developing	BBB/Positive/—	June 29, 2006.	Please see Westcoast Energy Inc.

Table 2

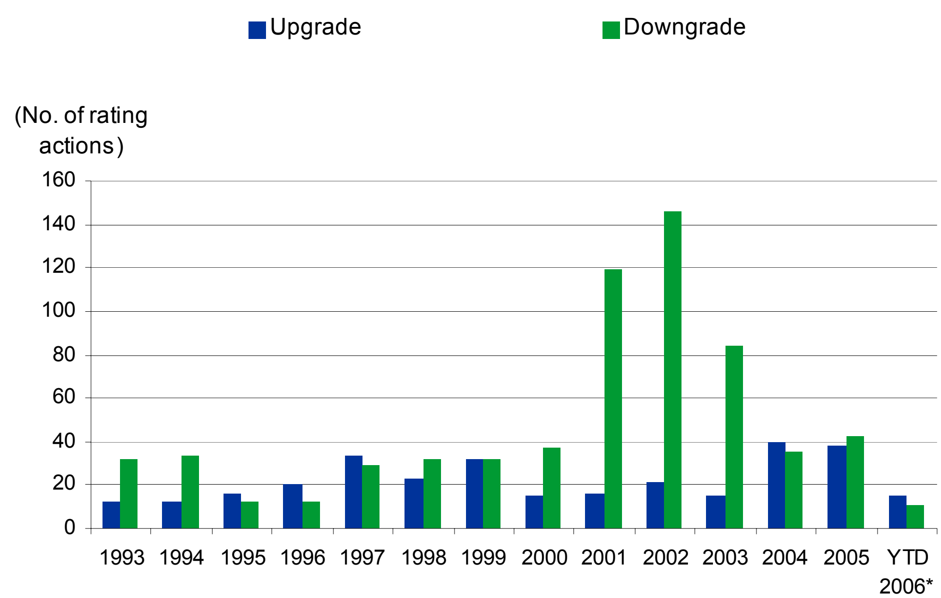
Rating/Outlook/CreditWatch Actions (cont.'d)

Issuer	To	From	Date*	Reason
Westcoast Energy Inc.	BBB/Positive/—	BBB/Stable/—	May 25, 2006	Standard & Poor's revised the outlook on the Duke Energy family of companies to positive as a result of Duke Energy's recent announcement to sell Cinergy's commercial trading and marketing operations. The sale, which could be completed before the end of the year, should contribute to a further moderation in business risk, as well as materially reduce collateral requirements.
Westcoast Energy Inc.	BBB/Developing/—	BBB/Positive/—	June 29, 2006.	As part of Duke Capital, the outlooks on Westcoast Energy and wholly owned subsidiary, Union Gas, were revised to developing. The outlook revision reflects concern as to how the proposed new gas company will be capitalized and funded upon completion of Duke Energy's planned separation of the electric and natural gas operations effective Jan. 1, 2007.

Dates represent the period from Jan. 31, 2006, to July 21, 2006, covered by this report card. *Guaranteed debt rating. ¶Debt rating. NR—Not rated.

Rating Trends

Global Utilities Issuer Upgrades Versus Downgrades



*As of July 17, 2006. Source: Standard & Poor's Global Fixed Income Research.

Contact Information

Table 3

Selected Articles	
Article Title	***Publication Date***
Industry Report Card: Canadian Crude Oil Firms Thrive While Natural Gas Companies Face Challenges	July 18, 2006
U.S. is Looking at a Paced Reemergence of the Nuclear Power Option	June 26, 2006
Industry report Card: Top 48 Global Utilities	June 1, 2006
CreditStats: Standard & Poor's Revises Statistical Practices	May 15, 2006
The Future Looks Heavy For The Canadian Oil And Gas Industry	May 6, 2006
Industry Report Card: U.S. Oil And Gas	Apr. 28, 2006
Peer Comparison: North American Stand Alone Transmission Companies Deliver Electricity...And Profits	Apr. 26, 2006
Energy Policy Act Of 2005 May Spark More Electric Transmission Investment In U.S.	March 30, 2006
Credit FAQ: Kinder Morgan Inc. And Kinder Morgan Energy Partners L.P.	Feb. 23, 2006
Industry report card: Canadian Utility Sector	Feb. 1, 2006

Table 4

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Comments and ratings reflect available public data as of July 21, 2006.

Gas & Electrical

August 8, 2006
Research Comment

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Industry Rating: Market Perform

The Coming Winter – OEB Staff Proposals Could Freeze Capital Out of Ontario LDCs

Summary

- On July 25, Staff of the Ontario Energy Board issued its second draft Staff Discussion Paper on the cost of capital and the 2nd generation incentive regulation mechanism. We have assessed this second discussion paper, particularly its recommended approach for determining the allowed return on equity.
- As set out herein, we believe that the appropriate equity risk premium is between 500 and 621 basis points. Using the June Consensus Estimate and a spread between the 10 and 30-year bonds of approximately 5 basis points, we believe that the 2007 ROE for Ontario's local distribution utilities should be between 10.25% and 10.86%. An allowed ROE in this range would likely eliminate the need for ROE incentives and recognizes that investors require a minimum return of 10% on utility investments.
- If Staff recommendations, particularly those relating to return on equity, are adopted and implemented by the Board, it may indeed be a long, cold winter for utility investors.

On July 25, Staff of the Ontario Energy Board issued its second draft Staff Discussion Paper on the cost of capital and the 2nd generation incentive regulation mechanism. We have assessed this second discussion paper, particularly its recommended approach for determining the allowed return on equity. We note the following:

- This second discussion paper does not address the issues raised in our comment dated June 27, 2006 in which we assess the short-comings of Staff's first discussion paper.
- Our comments herein are in addition to our June 27 comments.
- We have grouped our remarks as follows:
  - General remarks relating to the need for a utility to recover its cost of capital.
  - Fair Return issues that are prevalent throughout Staff's second discussion paper.
  - Continued shortcomings arising from the exclusive use of the Capital Asset Pricing Model to determine the equity risk premium to the risk free rate.
- As set out herein, we believe that the appropriate equity risk premium is between 500 and 621 basis points. Using the June Consensus Estimate and a spread between the 10 and 30-year bonds of approximately 5 basis points, we believe that the 2007 ROE for Ontario's local distribution utilities should be between 10.25% and 10.86%. An allowed ROE in this range would likely eliminate the need for ROE incentives and recognizes that investors require a minimum return of 10% on utility investments.
- If Staff recommendations, particularly those relating to return on equity, are adopted and implemented by the Board, it may indeed be a long, cold winter for utility investors.

We believe that the following points are relevant about the Staff's July 25, second Discussion Paper, as it relates to the equity cost of capital, in particular:

General Remarks:

- Throughout the paper, Staff discussed why it chose a particular approach. Unfortunately, Staff has not materially advanced its thinking with respect to alternatives and specific remedies to the shortcomings related to the Capital Asset Pricing Model referenced in our June 27 research report entitled, "2007 ROE Preview – The Uglier Get Uglier and Is there Trouble Brewing in Ontario?" and continues to advocate the use of forward interest rate curves to determine the risk free rate. We continue to oppose the use of this untested and inappropriate methodology.
- Staff invites Ontario electricity distributors to demonstrate that they have had difficulty attracting bank financing for capital investments. We note the inherent flaw with Staff's approach: if a distribution utility can affirmatively demonstrate that it has had difficulty issuing debt in financial markets or difficulty attracting bank financing for capital investments then the fair return standard has already been violated and utility distribution rates are not just and reasonable. In this regard, the Board would then have already failed in its obligation to fix fair and reasonable rates. As stated by the Federal Court of Appeal in its decision dated February 16, 2004, "In the long run, unless a regulated enterprise is allowed to earn its cost of capital, both debt and equity, it will be unable to expand its operations or even maintain existing ones. Eventually it will go out of business. This will harm not only its shareholders, but also the customers it will no longer be able to service."
- Staff does not apparently appreciate the need to establish a reasonable or fair cost of capital. The Federal Court of Appeal also stated that "even though cost of capital may be more difficult to estimate than some other costs, it is a real cost that the utility must be able to recover through its revenues. If the Board does not permit the utility to recover its cost of capital, the utility will be unable to raise new capital or engage in refinancing as it will be unable to offer investors the same rate of return as other investments of similar risk. As well, existing shareholders will insist that retained earnings not be reinvested in the utility" (February 16, 2004, page 5). We note that the Board has faced continued pressure to allow the sale of or organization of utility assets into income trusts. We believe that the entire utility in an income trust discussion is prima facie evidence that shareholders want their capital back because ROEs are too low, that only by incrementally pricing new capital for all required capital projects in the market at the time that it is needed can (as a utility would have to do if organized as a trust) the utility be assured of earning its cost of capital, and that similar efforts to collect income taxes in a trust structure when none are paid by the utility, is a also an attempt to increase ROE because the ROE currently allowed by the Board is too low. We maintain our position that utilities should not be organized in income trusts and that ROEs are too low.

Fair Return Standard

- **Key Objectives:** Staff outlines six key objectives that have provided guidance when formulating its proposals. Objectives 1 and 4 are of particular interest:

  Objective 1: Protect customers in relation to prices. This requires a consideration of the impacts of rate adjustments while at the same time ensuring that prudently incurred costs required for the operation of the distributor are recovered from customers.

Objective 4: Ability to raise the financing necessary to invest in distribution infrastructure to enhance service quality and reliability. This includes allowing distributors the opportunity to earn a reasonable return on shareholder capital and to maintain their financial viability.

With respect to Objective 1, we note that Staff recognizes the balancing of interests that are inherent in the Fair Return Standard, as established by Canada's Supreme Court and United States Supreme Court and accepted by the National Energy Board in 1971. A fair or reasonable rate of return should:

1. Be comparable to the return available from the application of the invested capital to other enterprises of like risk (the comparable earnings standard).
2. Enable the financial integrity of the regulated enterprise to be maintained and permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the financial integrity and capital attraction standards).
3. Achieve fairness both from the viewpoint of the customers and from the viewpoint of present and prospective investors (appropriate balance of customer and investor interests).

However, we believe that Staff may be interpreting Objective 1 as the need to reduce the cost of capital, which Staff identifies to be very important for distributors as it represents about half of the revenue requirement, as a way of protecting customers from higher prices. We again note that, as per the Federal Court of Appeal, the impact on customers or consumers cannot be a factor in the determination of the cost of equity capital. With respect to any resulting increase in tolls, cost of capital may be a relevant factor for the Board to consider in determining the way in which a utility should recover its costs. However, the rate of return on the equity component of the utility's deemed capital structure is unaffected by the impact of tolls on customers or consumers.

Objective 4 imposes a priority to the criteria that determine whether a return is fair. We steadfastly believe that no one standard takes precedence over the other – all of the named standards must be met in order for a return to be determined fair; moreover the ability to raise incremental financing (arguably the capital attraction standard), does not "include" the comparable earnings standard and the financial integrity standard; they are separately named standards – satisfaction of the capital attraction standard does not automatically mean that the comparable earnings, financial integrity and appropriate balance standards have been met.

- **Interrelated Objectives:** Staff states that in setting a regulated cost of capital the Board has to keep in mind two interrelated objectives: the need to ensure that distributors have sufficient ability to attract capital; and the need to ensure that consumers are not required to pay any more in rates than is necessary to meet the capital needs and reasonable operating profits of the distributors. This entire statement is problematic for two reasons:

1. Staff is misconstruing the Fair Return Standard. As highlighted above, all four standards must be satisfied for the Fair Return Standard to be achieved. Meeting the capital attraction standard alone does not make a return fair or reasonable.

2. A rate of return on capital (debt and equity) and a capital structure that meets the Fair Return Standard automatically meets Staff's test that consumers are not required to pay too much.

- **Incentives for New Investment:** Staff proposes the use of a return on equity premium of 50 to 150 basis points to provide an incentive for new infrastructure investment. As proposed by Staff, existing rate base as of 2006 would earn a return of 8.37%, while new distribution infrastructure added to rate base in 2007 and beyond would be at an ROE of between 8.87% to 9.87%. We believe that Staff's proposal has the following inherent difficulties:

1. **ROE Scenarios Too Low:** We believe that Staff's willingness to explore the use of an ROE premium to provide an incentive for new infrastructure is an outright admission that the return on equity calculated pursuant to the CAPM methodology recommended by Staff is simply too low.

2. **Incentives are not Needed If Allowed ROE is Fair:** We point out that utilities do not require incentives to invest in their primary business if the allowed ROE is Fair.

3. **Violation of Fair Return Standard:** In order to achieve the appropriate balance of customer and investor interests, the fair return must, among other things, achieve fairness from the viewpoint of present and prospective investors. We believe that the use of incentives for new capital discriminates against the present providers of capital and differentiates between new and existing capital, violating the Fair Return Standard. The financial market makes no such distinction between current and prospective capital, and re-prices an organization's entire cost of capital each trading day.

4. **Administratively Complex:** Staff has not set out what type of capital project qualifies for an incentive. How long will an incentive be earned? Can the "incentive" return be clawed back pursuant to a separate proceeding? How can an ROE 50 to 150 basis points higher than the Fair Return allowed by the Board also be Fair? The implementation of such incentives is complex and is unnecessary if the return on equity allowed on all equity capital invested in rate base is Fair.

5. **Incentives Are Not Likely to Affect Credit Concerns:** We believe that the use of higher allowed returns on a small part, but not all of a utility's rate base is unlikely to mitigate the credit issues facing the utility sector in general, due to exorbitantly low deemed equity and punitive rates of return on equity.

6. **Bad Message for Capital Markets:** We believe that this proposal sends a very bad message to providers of capital: once capital is embedded in a utility's cost of service, it is stuck and investors have no choice but to accept the return on equity determinations of the Board, no matter how bad. It is important to remember that new capital today, becomes old capital tomorrow, pursuant to Staff's proposal. We note that recent court decisions have clearly set out the limited options that utility shareholders have to successfully challenge cost of capital determinations of the relevant regulatory tribunal:

   - Evidenciary Burden is too high: in the Federal Court of Appeal decision dated February 16, 2004, the Court determined that TransCanada PipeLines Limited had not demonstrated that the National Energy Board took the impact on customers or consumers into account in making its determination of the MainLine's required rate of return on equity, could not demonstrate that the Board had fettered its discretion regarding the continued use of the Multi-Pipeline cost of capital decision, nor that the Board wrongly discarded evidence relevant in the determination of the cost of equity. Despite the cost and extensive evidenciary record, the needs of shareholders and other providers of capital were ignored.

- Courts are unwilling to challenge the general expertise of the administrative decision maker. As set out in the February 9, 2006 decision of the Supreme Court of Canada (ATCO Gas & Pipelines Ltd. v. Alberta Energy & Utilities Board), administrative tribunals or agencies are statutory creations, and that the Board is a specialized body with a high level of expertise regarding the objects of its regulation. Courts will typically defer to the Board if the issue under consideration is a technical one or in an area where the tribunal has been held to have greater expertise than the court. We believe that the cost of equity issue is likely to fall into this category – short of an error in Law, we believe that an appellate court is unlikely to overturn the decision of the regulatory tribunal as it relates to the allowed return on equity.

Capital Asset Pricing Model:

The Capital Asset Pricing Model (CAPM) is one of the methods available to Board Staff to determine the relevant equity risk premium to be used in its automatic adjustment mechanism. In our previous comment dated June 27 (which we incorporate by reference), we set out a number of concerns with CAPM which require the use of alternative and/or supplemental methods to determine the appropriate equity risk premium. This second report is largely deficient in this regard, as Staff recommends using only CAPM to set the equity risk premium. There are a significant number of problems with Staff's apparent assessment of the alternatives to CAPM:

- **Manipulation of Accounting Earnings:** Staff rejects the use of the Comparable Earnings (CE) method to determine the appropriate equity risk premium. Staff asserts that CE has long been acknowledged to place a greater reliance on accounting definitions of earnings which leads to published values that are too easily manipulated. In the post-Enron area, this should not need emphasis. We find these statements to be outrageous and unsupportable, from a number of fronts:

  1. Staff does not provide evidence that financial statements prepared in accordance with the CICA Handbook overstate earnings.
  2. It has not provided evidence of corporate malfeasance in the preparation of financial statements in those entities subject to the Board's purview.
  3. It has not provided copies of filed statements or evidence submitted to the CICA, Ontario Securities Commission or relevant authorities setting out alleged abuses.
  4. Staff is suggesting that the financial market cannot rely on the determination of net income as set out in audited financial statements, even though the integrity of financial reports is a critical underpinning of a fully functioning and efficient capital market. We also note that Board Staff, in fact all Canadian regulators, expect the financial market to accept significant deviations from GAAP and the standards otherwise set by the CICA pursuant to so called "rate-regulated accounting".

5. Staff has used this argument to summarily discard evidence filed in conjunction pursuant to its first discussion paper by Newmarket Hydro Ltd. Newmarket filed evidence relating to the allowed 2005 ROE for 28 regulated utilities companies, representing 20 state regulators, with an average allowed ROE of 10.58% and an average equity risk premium of 621 basis points.

We believe that Staff is damaging its credibility by making this unsubstantiated assertion.

- **Discounted Cash Flow Approach – Confusion:** Staff also discards the use of the Discounted Cash Flow (DCF) method to determine the equity risk premium. We believe that Staff is confusing the internal rate of return with the cost of capital. Staff asserts that the DCF for traded firms relies on projecting future cash flows and deriving the discount rate that yields the market value of equity. The implication is that the cost of equity or discount rate will equate future cash flow and the price of the stock, or the internal rate of return (IRR). The IRR is not a cost of equity, it is merely the discount rate that makes the present value of the cash proceeds expected from an investment equal to the present value of the cash outlays required by the investment. Rates of return, on the other hand, are always calculated for one period.

  As highlighted in our March 15, edition of *Wires, Pipes & Btus*, on March 2, an Administrative Law Judge (ALJ) with the U.S. Federal Energy Regulatory Commission issued an order relating to the Kern River Gas Transmission Company's April 30, 2004 general rate case filing. In this order, the ALJ highlights a number of FERC's rate-setting approaches including the DCF approach: the DCF methodology projects investor long-term growth expectations by adding average dividends yields to estimated constant growth in future dividends. The DCF methodology is based on the premise that a stock is worth the present value of its future cash flows discounted at a market rate commensurate with the stock's rise. Under the DCF formula, the cost of capital is equated with the dividend yield plus the estimated constant growth in dividends to be reflected in capital appreciation. The DCF value of a stock determined in this manner does not necessarily equal the observed trading price of the equity and the DCF cost of equity is not an IRR.

- **ROE Scenarios Flawed:** Staff tries again with CAPM, providing four ROE scenarios for electric and rate regulated entities in both the short term (60 month average market return and one year riskless period) and long term (120 months average market return and 15 year riskless period). We note the following:

1. The proxy group for the "Electrics" includes: ATCO, Canadian Utilities, Coast Mountain Power Corp., Maxim Power Corp., TransCanada Corporation, Fortis Inc., TransAlta Power, L.P., and Canadian Hydro Developers. Again this proxy group is deficient: Coast Mountain Power, Maxim Power, TransAlta Power, LP and Canadian Hydro Developers (50% of the proxy group) are pure-play independent power companies with no rate regulated operations. It is unclear why a similar exercise was not conducted for the U.S. utility universe.

2. The proxy group for the "All Rate Regulated" includes the foregoing names plus Enbridge Inc., Pacific Northern Gas, Manitoba Telecom Services Inc., and TELUS Corp. Neither proxy group includes Emera Inc., even through substantially all of its earnings and revenues arise from rate regulated operations in Nova Scotia and Maine. In the 11 years that we have been issuing recommendations to investors regarding the purchase, sale or continued ownership of pipeline and energy utility equities, we have

not included telecom names in our relevant comparables group, due to the divergent nature of the businesses since the early 1990s.

3. Staff uses a 15-year riskless period in its long-term scenario. This term is inconsistent with the 5, 10, and 30 year standard for the issuance of debt securities. It is unclear why the assessment period for the market return is not equal to the period used to assess the risk free rate.

4. The resulting return on equity for the Electrics of 6.61% and 7.50% in the short and long term and 6.65% and 8.37% for the All Rate Regulated in the short and long term, continue to be inadequate, confiscatory and punitive. The implied risk premium of 196 and 249 basis points pursuant to the Electrics, short and long term scenarios, respectively and 200 and 336 basis points pursuant to the All Rate-Regulated (including a 50 basis point allowance for flotation and transaction costs) is substantially less than the approximately 380 basis point premium allowed based on the Cannon method (updated in 2000, contained in Appendix B) and the 2006 ROE as described in the 2006 Electricity Distribution Rate Handbook. That equity risk premiums are lower than that established by Cannon in 1998 is counterintuitive, given that the risks faced by local distribution utilities in Ontario today are higher than in 1998. We have witnessed: (i) higher political risk – the imposition of rate freezes and the consequential inability to pass prudently incurred utility costs on to customers; (ii) the implementation of a "Conservation Culture" in Ontario, with the coincident demand side management and smart meter initiatives; (iii) legal and regulatory impediments that have erected barriers to consolidation resulting in the continued operation of over 80 local distribution utilities; (iv) lack of incentives and clear rate structures that will facilitate the consolidation of location distribution utilities and provide merged entities with an adequate time frame over which to recover transaction costs and investments; and (v) the development of an unprecedented capital works program that is likely to span the extended forecast period. In this regard, Staff has not justified why a lower equity risk premium is appropriate now versus in 1998.

We believe that:

1. The approach used to determine the equity risk premium should not depend solely on the Capital Asset Pricing Model, given the limitations highlighted in this report and our June 27 report. We believe that the CE and DCF methods must also be used.

2. The equity risk premium should be between the 380 basis points currently implied by the Cannon study and the 621 basis point premium in evidence in comparable investments in the United States, as filed by Newmarket Hydro in its evidence. We strongly believe that the use of 380 basis point lower end of the range results in a confiscatory ROE and believe that the ERP used should be in the upper half of the range or approximately 500 basis points to 621 basis points.

3. We believe that the Consensus Forecast should continue to be used to determine the risk free rate. The June Consensus Forecast would render a long-term risk free rate of approximately 4.65% (4.60% and a spread between the 1- and 30-year bonds of 5 basis points).

4. The resulting ROE using this approach would be 9.65% and 10.86%. We believe that this range, particularly the upper end of the range (10.25% to 10.86%) is more appropriate,

would likely eliminate the need for incentives and recognizes that investors require a minimum return of 10% on utility investments.

Finally, we believe that if Staff's recommendations, particularly those relating to return on equity, are adopted and implemented by the Board, investor capital may be frozen out of the Ontario local distribution utility sector and that an extremely negative precedent will have been created for other utility regulators across Canada. It may be a long, cold winter, indeed for utility investors.

Analyst's Certification

I, Karen Taylor, CFA, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

I, Michael McGowan, CA, CFA, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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