

**FortisBC Energy Inc.**  
**Management Discussion & Analysis**  
**For the Three and Six Months Ended June 30, 2014**  
**Dated August 1, 2014**

*The following FortisBC Energy Inc. ("FEI" or the "Corporation") Management Discussion & Analysis ("MD&A") has been prepared in accordance with National Instrument 51-102 – Continuous Disclosure Obligations. Financial information for 2014 and comparative periods contained in the following MD&A has been prepared in accordance with accounting principles generally accepted in the United States ("US GAAP") and is presented in Canadian dollars unless otherwise specified. The MD&A should be read in conjunction with the unaudited interim consolidated financial statements and notes thereto for the three and six months ended June 30, 2014, with 2013 comparatives, prepared in accordance with US GAAP and the annual audited consolidated financial statements and notes thereto together with the MD&A for the year ended December 31, 2013, with 2012 comparatives, prepared in accordance with US GAAP.*

*In this MD&A, FEVI refers to FortisBC Energy (Vancouver Island) Inc., FEW refers to FortisBC Energy (Whistler) Inc., FAES refers to FortisBC Alternative Energy Services Inc., FHI refers to the Corporation's parent, FortisBC Holdings Inc., FBC refers to FortisBC Inc., and Fortis refers to the Corporation's ultimate parent, Fortis Inc.*

## **FORWARD LOOKING STATEMENT**

Certain statements in this MD&A contain forward-looking information within the meaning of applicable securities laws in Canada ("forward-looking information"). The words "anticipates", "believes", "budgets", "could", "estimates", "expects", "forecasts", "intends", "may", "might", "plans", "projects", "schedule", "should", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words.

The forward-looking information in this MD&A includes, but is not limited to, statements regarding the Corporation's estimated costs for the Tilbury LNG Facility Expansion Project and associated in-service date; expectations to meet interest payments on outstanding indebtedness from operating cash flows; the Corporation's expected level of capital expenditures and its expectations to finance those capital expenditures through credit facilities, equity injections from FHI and debenture issuances; the Corporation's expectations for employee future benefit costs; the Corporation's belief that changes in consumption levels and changes in the commodity cost of natural gas do not materially impact earnings as a result of regulatory deferral accounts; the forecast average rate base for 2014; and the expected amalgamation of FEI, FEVI, FEW and Terasen Gas Holdings Inc.

The forecasts and projections that make up the forward-looking information are based on assumptions, which include but are not limited to: receipt of applicable regulatory approvals and requested rate orders; absence of administrative monetary penalties; the ability to report under US GAAP beyond the Canadian securities regulators exemption to the end of 2018 or earlier; absence of asset breakdown; absence of environmental damage and health and safety issues; absence of adverse weather conditions and natural disasters; ability to maintain and obtain applicable permits; the adequacy of the Corporation's existing insurance arrangements; the First Nations' settlement process does not adversely affect the Corporation; the ability to maintain and renew collective bargaining agreements on acceptable terms; no material change in employee future benefits costs; the ability of the Corporation to attract and retain skilled workforces; absence of information technology infrastructure failure; absence of cyber-security failure; continued energy demand; the ability to arrange sufficient and cost effective financing; no material adverse ratings actions by credit ratings agencies; the competitiveness of natural gas pricing when compared with alternate sources of energy; continued population growth and new housing starts; the availability of natural gas supply; and the ability to hedge certain risks including no counterparties to derivative instruments failing to meet obligations.

The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors which could cause results or events to differ from current expectations include, but are not limited to: regulatory approval and rate orders risk (including the risk of imposition of administrative monetary penalties); continued reporting in accordance with US GAAP risk; asset breakdown, operating, maintenance and expansion risk; environment, health and safety matters risk; weather and natural disasters risk; permits risk; underinsured and uninsured losses; risks involving First Nations; labour relations risk; employee future

benefits risk; human resources risk; information technology infrastructure risk; cyber-security risk; interest rates risk; impact of changes in economic conditions risk; capital resources and liquidity risk; competitiveness and commodity price risk; counterparty credit risk; natural gas supply risk; and, other risks described in the Corporation's most recent Annual Information Form. For additional information with respect to these risk factors, reference should be made to the section entitled "Business Risk Management" in this MD&A and the Corporation's MD&A for the year ended December 31, 2013.

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

## CORPORATE OVERVIEW

The Corporation is the largest distributor of natural gas in British Columbia ("BC"), serving approximately 853,000 residential, commercial and industrial and transportation customers in more than 100 communities. Major areas served by the Corporation are Greater Vancouver, the Fraser Valley and the Thompson, Okanagan, Kootenay and North Central Interior regions of BC. The Corporation provides transmission and distribution services to its customers, and obtains natural gas supplies on behalf of most residential, commercial and industrial customers. Gas supplies are sourced primarily from northeastern BC and, through the Corporation's Southern Crossing Pipeline, from Alberta.

The Corporation is an indirect, wholly-owned subsidiary of Fortis, a diversified, international utility holding corporation having investments in distribution, transmission and generation utilities, as well as commercial real estate and hotel operations.

## REGULATION

### Customer Rates and Quarterly Gas Cost Changes

Customer rates include both the delivery charge, and the commodity and midstream charges. The commodity cost of natural gas and midstream costs are flowed through to customers without mark-up.

In addition to annual delivery rate changes, the Corporation reviews natural gas and propane commodity and midstream charges every three months with the British Columbia Utilities Commission ("BCUC") in order to ensure the rates charged to customers are sufficient to cover the cost of purchasing natural gas and contracting for midstream resources such as third-party pipeline or storage capacity.

Overall, residential rates increased in the second quarter of 2014 as compared to the second quarter of 2013. The table below shows the rate changes since January 1, 2013 for a typical Lower Mainland residential customer:

	2013				2014	
	Jan 1	April 1	July 1	Oct 1	Jan 1	April 1
Effective rate per gigajoule	\$9.36	\$9.36	\$10.00	\$9.36	<b>\$9.69</b>	<b>\$11.06</b>
Percentage change in rate	1.6%	-	6.8%	(6.4%)	<b>3.5%</b>	<b>14.1%</b>

When comparing June 30, 2014 to June 30, 2013, an average bill for a FEI residential customer increased by approximately 18.2 per cent, due to an increase in the cost of natural gas partially offset by a decrease in delivery rates mainly relating to the Generic Cost of Capital ("GCOC") decision described below.

### Amalgamation

In February 2014, the BCUC approved the amalgamation of FEI, FEVI, FEW and Terasen Gas Holdings Inc. subject to the consent of the Lieutenant Governor in Council. The BCUC approved the adoption of common rates for natural gas delivery to all customers except those in the Fort Nelson service area and approved the phase-in to common rates over a three year period. The amalgamation received the consent of the Lieutenant Governor in Council in May 2014 and is expected to be effective on December 31, 2014.

## **FEI Application for Multi-year Performance Based Ratemaking Plan for 2014 to 2018 (“2014 PBR Application”)**

In June 2013, FEI filed its 2014 PBR Application with the BCUC. Pursuant to an Evidentiary Update filed in February 2014, the application assumes a forecast average rate base of approximately \$2,778 million for 2014 and requests approval of a delivery rate increase for 2014 of 0.6 per cent determined under a formula approach for operating and maintenance costs and capital costs, and a continuation of this rate setting methodology for a further four years. Effective January 1, 2014, the BCUC has provided approval for an interim refundable delivery rate increase of 1.4 per cent as determined in the Evidentiary Update filed in September 2013.

The 2014 PBR Application proposes mechanisms for improving operating efficiencies. Operation and maintenance costs and base capital expenditures during the PBR period are subject to a formula reflecting incremental costs for customer growth and inflation, less a fixed productivity adjustment factor. In addition, the 2014 PBR Application requests a 50/50 sharing of annual earnings above or below the allowed return on equity over the PBR period.

The regulatory process to review the application included an oral public hearing in March 2014, and will continue through 2014, with a decision expected in the third or fourth quarter of 2014.

## **Allowed Return on Equity (“ROE”) and Capital Structure**

In February 2012, the BCUC established that a GCOC Proceeding would occur and in April 2012, issued a final scoping document identifying specific items that would be reviewed as part of the GCOC Proceeding.

Pursuant to a BCUC order released in December 2012, effective January 1, 2013, the approved 2012 ROE and capital structure for the Corporation and all other regulated entities in BC that rely on the benchmark utility, which was determined to be FEI, to establish rates were to be maintained and made interim. In May 2013, the BCUC issued its decision on the first stage of the GCOC Proceeding. The decision determined that the ROE of the benchmark utility would be set at 8.75 per cent with a 38.5 per cent common equity component, both effective January 1, 2013. The common equity component of capital structure will remain in effect through December 31, 2015. Effective January 1, 2014, the BCUC has also introduced an Automatic Adjustment Mechanism (“AAM”) to set the ROE on an annual basis for the Corporation. The AAM will take effect when the actual long-term Government of Canada bond yield exceeds 3.8 per cent. The AAM will be in effect until December 31, 2015. In January 2014, the BCUC confirmed that the necessary conditions for the AAM to be triggered for the 2014 ROE have not been met, therefore the benchmark ROE remains at 8.75 per cent for 2014.

Once amalgamation of the gas utilities has been affected, the ROE and capital structure for the amalgamated entity will be set to equal the benchmark utility, FEI.

## **US GAAP**

In January 2014, the Ontario Securities Commission (“OSC”) issued a relief order which permits the Corporation to continue to prepare its financial statements in accordance with US GAAP, until the earliest of: (i) January 1, 2019; (ii) the first day of the financial year that commences after the Corporation ceases to have activities subject to rate regulation; or (iii) the effective date prescribed by the International Accounting Standards Board (“IASB”) for the mandatory application of a standard within International Financial Reporting Standards (“IFRS”) specific to entities with activities subject to rate regulation. The OSC relief order effectively replaces and extends the OSC’s previous relief order, which was due to expire January 1, 2015.

The BCUC had previously approved the Corporation’s request to adopt US GAAP for regulatory purposes until December 31, 2014. In May 2014, FEI applied for approval to continue the use of US GAAP for regulatory purposes effective January 1, 2015. In July 2014, the BCUC granted the requested approval, until such time as FEI no longer has an OSC exemption to use US GAAP or is no longer reporting under US GAAP for financial reporting purposes, whichever is earlier.

## CONSOLIDATED RESULTS OF OPERATIONS

	Quarter			Year to Date		
Periods Ended June 30	2014	2013	Variance	2014	2013	Variance
Gas sales (Petajoules (PJs))	31	32	(1)	99	97	2
(\$ millions)						
Revenue	239	200	39	690	628	62
Expenses						
Cost of natural gas	108	79	29	333	285	48
Operation and maintenance	44	43	1	92	91	1
Depreciation and amortization	38	36	2	76	73	3
Property and other taxes	12	13	(1)	24	26	(2)
	202	171	31	525	475	50
Operating income	37	29	8	165	153	12
Finance charges	33	29	4	62	58	4
Earnings before income taxes	4	-	4	103	95	8
Income taxes	-	1	(1)	30	21	9
Net earnings (loss)	4	(1)	5	73	74	(1)

### Gas Sales

For the three months ended June 30, 2014, gas sales volumes were comparable to the corresponding period in 2013.

For the six months ended June 30, 2014, gas sales volumes were higher compared to the corresponding period in 2013 primarily due to higher consumption by residential, commercial and transportation customers as a result of colder weather in the first quarter of 2014 as compared to 2013.

### Net Earnings

The Corporation reported net earnings of \$4 million for the three months ended June 30, 2014 and net earnings of \$73 million for the six months ended June 30, 2014, compared to a net loss of \$1 million and net earnings of \$74 million in the corresponding periods of 2013.

The Corporation's earnings for the three and six months ended June 30, 2014 were based on an allowed ROE of 8.75 per cent and a deemed equity component of capital structure of 38.5 per cent, which resulted from the BCUC decision on the first stage of the GCOC Proceeding received in May 2013. In 2013, the effect of the GCOC decision was reflected in the second quarter of 2013, retroactive back to January 1, 2013, therefore the earnings for the first quarter of 2013 were based on an allowed ROE of 9.5 per cent and a deemed equity component of capital structure of 40.0 per cent.

The increase in earnings of \$5 million for the second quarter ended June 30, 2014 as compared to June 30, 2013 was primarily due to the retroactive negative impact of the GCOC decision reflected in the second quarter of 2013 relating to the first quarter of 2013.

For the six months ended June 30, 2014, earnings were comparable to the six months ended June 30, 2013.

### Revenue and Cost of Natural Gas

For the three and six months ended June 30, 2014, revenues increased by \$39 million and \$62 million, respectively, compared to the corresponding periods in 2013. For the three and six months ended June 30, 2014, cost of natural gas increased by \$29 million and \$48 million, respectively, compared to the corresponding periods in 2013.

Higher revenues and cost of natural gas for the three months and six months ended June 30, 2014 were primarily due to higher commodity costs.

The increase in revenues for the quarter ended June 30, 2014 as compared to June 30, 2013 was also due to the retroactive negative impact of the GCOC decision reflected in the second quarter of 2013 relating to the first quarter of 2013. For the six months ended June 30, 2014, increased gas sales also contributed to higher revenues and cost of natural gas.

Additionally, higher revenue from the current year's tax loss utilization plan ("TLUP") contributed to higher revenue for the three and six months ended June 30, 2014. A similar TLUP was put in place in the third quarter of 2013.

As part of the TLUP, the Corporation received dividend income from FHI relating to a \$1,400 million investment in preferred shares. A TLUP is a series of transactions, whereby the Corporation sets up an investment in an affiliate's preferred shares and issues subordinated debt to that affiliate; these two financial instruments are shown on a net basis. The Corporation receives non-taxable dividend income on the preferred shares and pays tax deductible interest on the debt. The effect of this transaction is to transfer tax losses between affiliated entities.

Changes in consumption levels of sales customers and changes in the commodity cost of natural gas do not materially impact earnings as a result of regulatory deferral accounts.

### **Operation and Maintenance Expense**

For the three months and six months ended June 30, 2014, operation and maintenance expense was comparable with the corresponding periods in 2013 as higher pension costs were offset by lower contracting costs.

### **Depreciation and Amortization**

For the three and six months ended June 30, 2014, depreciation and amortization expense increased by \$2 million and \$3 million, respectively, compared with the corresponding periods in 2013. The increase was due to higher amortization of regulatory asset deferral accounts and higher depreciation expense due to the increase in the depreciable asset base of the Corporation.

As applied for in the 2014 PBR Application and effective January 1, 2014, depreciation of property, plant and equipment and amortization of intangible assets commences the year after the asset is available for use. Prior to January 1, 2014, depreciation and amortization commenced in the month after the asset was available for use.

### **Finance Charges**

For the three and six months ended June 30, 2014, finance charges increased by \$4 million in both periods compared to the corresponding periods in 2013. The increase was primarily a result of the Corporation having in place a TLUP (a similar TLUP was put in place in the third quarter of 2013) which generated higher interest expense compared to the same periods in 2013.

### **Income Taxes**

For the three months ended June 30, 2014, income tax expense decreased by \$1 million, while for the six months ended June 30, 2014 income tax expense increased by \$9 million, respectively, compared to the corresponding periods in 2013. The decrease in income tax expense for the three months was mainly due to the Corporation having in place a TLUP which generated lower tax expense compared to the same period in 2013 partially offset by higher pre-tax earnings.

The increase in income tax expense for the six months was mainly due to lower deductible temporary differences, higher pre-tax earnings, higher taxable permanent differences and an increase in the Canadian federal and BC provincial combined statutory tax rate from 25.0 per cent used in the first six months of 2013 to 26.0 per cent used in the first six months of 2014, partially offset by the TLUP.

## CONSOLIDATED FINANCIAL POSITION

The following table outlines the significant changes in the consolidated balance sheets as at June 30, 2014 compared to December 31, 2013:

Balance Sheet Item	Increase (Decrease) (\$ millions)	Explanation
Accounts receivable	(51)	The decrease was mainly due to a decrease in trade accounts receivable and unbilled revenues due to seasonality, partially offset by an increase in the buildup of the equal payment plan.
Regulatory assets	37	The increase was primarily due to increases in the regulated asset for deferred income taxes, the commodity cost reconciliation deferral account and costs related to the energy efficiency and conservation program.
Property, plant and equipment	24	The increase was primarily due to \$83 million in capital expenditures incurred during the period, partially offset by depreciation expense of \$54 million, contributions in aid of construction of \$1 million and non-cash accruals of \$3 million.
Regulatory liabilities	(20)	The decrease was primarily due to the decrease in regulated liability for deferred income taxes and a decrease in the commodity cost reconciliation deferral account.

## LIQUIDITY AND CAPITAL RESOURCES

### Summary of Consolidated Cash Flows

Six Months Ended June 30 (\$ millions)	2014	2013	Variance
Cash flow provided by (used for):			
Operating activities	177	200	(23)
Investing activities	(95)	(67)	(28)
Financing activities	(75)	(120)	45
Net increase in cash and cash equivalents	7	13	(6)

### Operating Activities

Cash flow provided by operating activities was \$23 million lower for the six months ended June 30, 2014 compared to the corresponding period in 2013 primarily due to changes in non-cash working capital.

### Investing Activities

Cash used for investing activities was \$28 million higher for the six months ended June 30, 2014 compared to the corresponding period in 2013. The increase was primarily due to increased property, plant and equipment expenditures.

### Financing Activities

Cash used for financing activities was \$45 million lower for the six months ended June 30, 2014 compared to the corresponding period in 2013. The decrease was primarily due to a decrease in dividends paid in 2014 as 2013 included a one-time dividend to reduce the common equity component of capital structure to 38.5 per cent as a result of the first stage of the GCOC Proceeding and a decrease in repayment of short-term notes in 2014 as compared to 2013.

During the six months ended June 30, 2014, the Corporation paid common share dividends of \$57 million (2013 - \$84 million) to its parent companies.



## Contractual Obligations

The following table sets forth the Corporation's contractual obligations due in the years indicated:

As at June 30, 2014	Total	Due Within 1 Year	Due In Year 2	Due In Year 3	Due In Year 4	Due In Year 5	Due After 5 Years
(\$ millions)							
Interest on long-term debt	1,738	105	101	86	76	76	1,294
Debt retirement and capital lease and finance obligations	1,660	7	81	207	7	31	1,327
Operating leases	15	3	3	3	2	2	2
Gas purchase contracts	372	220	152	-	-	-	-
Defined benefit pension plan funding contributions	40	17	16	7	-	-	-
<b>Totals</b>	<b>3,825</b>	<b>352</b>	<b>353</b>	<b>303</b>	<b>85</b>	<b>109</b>	<b>2,623</b>

Gas purchase contract commitments are based on gas commodity indices that vary with market prices. The amounts disclosed reflect index prices that were in effect at June 30, 2014.

## Capital Structure

The Corporation's principal business of regulated gas transmission and distribution requires ongoing access to capital in order to allow the Corporation to fund the maintenance, replacement and expansion of infrastructure. The Corporation maintains a capital structure in line with the deemed regulatory capital structure approved by the BCUC at 38.5 per cent equity and 61.5 per cent debt.

## Credit Ratings

In June 2014, Moody's Investors Service affirmed the long-term credit ratings of the Corporation of A1 for secured long-term debt and A3 for unsecured long-term debt and changed the rating outlook to stable from negative. There have been no other changes to the Corporation's credit ratings from those reported in the Corporation's 2013 annual MD&A.

## Projected Capital Expenditures

The projected capital expenditures for 2014 remain substantially unchanged from the description outlined in the Corporation's 2013 annual MD&A.

## Cash Flow Requirements

The Corporation's working capital requirements fluctuate seasonally based on natural gas consumption. Given the regulated nature of its business, the Corporation is able to maintain negative working capital balances. The Corporation maintains adequate committed credit facilities.

It is expected that operating expenses and interest costs will generally be paid out of operating cash flows, with varying levels of residual cash flow available for capital expenditures and/or for dividend payments. Cash required to complete capital expenditure programs is also expected to be financed from a combination of borrowings under credit facilities, equity injections from FHI and debenture issuances.

The Corporation's ability to service its debt obligations and pay dividends on its common shares is dependent on the financial results of the Corporation. Depending on the timing of cash payments, borrowings under the Corporation's credit facility may be required from time to time to support the servicing of debt and payment of dividends. The Corporation may have to rely upon the proceeds of new debenture issues to meet its principal debt obligations when due.

### Credit Facilities

As at June 30, 2014, the Corporation has a \$500 million syndicated credit facility available of which \$378 million was unused.

In July 2014, the Corporation extended its credit facility to mature in August 2016 on substantially similar terms to the facility it replaced.

(\$ millions)	June 30, 2014	December 31, 2013
Total credit facility	500	500
Short-term notes	(72)	(87)
Letters of credit outstanding	(50)	(50)
Credit facility available	378	363

### OFF-BALANCE SHEET ARRANGEMENTS

As at June 30, 2014, the Corporation had no material off-balance sheet arrangements, with the exception of letters of credit outstanding of \$50 million (December 31, 2013 - \$50 million).

### RELATED PARTY TRANSACTIONS

In the normal course of business, the Corporation transacts with its parent and other related companies under common control to provide or receive services and materials. The following transactions were measured at the exchange amount unless otherwise indicated.

#### Related Party Recoveries

The amounts charged to the Corporation's parent and other related parties under common control for the three and six months ended June 30 were as follows:

	Three months ended June 30		Six months ended June 30	
(\$ millions)	2014	2013	2014	2013
Natural gas transmission and distribution revenue recovered from FEVI (a)	1	1	2	2
Operation and maintenance expense charged to FEVI (b)	3	2	6	5
Operation and maintenance expense charged to FBC (c)	1	1	2	1
Other income recovered from FHI (d)	4	-	4	-
	9	4	14	8

- (a) The Corporation charged FEVI, a subsidiary of FHI, for transporting natural gas through the Corporation's pipeline system.
- (b) The Corporation charged FEVI for management services, labour and materials.
- (c) The Corporation charged FBC, a related company under common control, for office rent and management services.
- (d) As part of a TLUP, the Corporation received dividend income from FHI relating to a \$1,400 million investment in preferred shares.



## Related Party Costs

The amounts charged by the Corporation's parent and other related parties under common control for the three and six months ended June 30 were as follows:

	Three months ended June 30		Six months ended June 30	
(\$ millions)	2014	2013	2014	2013
Natural gas storage costs charged by FEVI (a)	4	4	8	8
Operation and maintenance expense charged by FBC (b)	1	1	3	2
Operation and maintenance expense charged by FHI (c)	3	3	6	6
Finance charges paid to FHI (d)	4	-	4	-
	<b>12</b>	<b>8</b>	<b>21</b>	<b>16</b>

- (a) FEVI charged the Corporation for storing natural gas at the Mt. Hayes LNG storage facility. These charges were included in regulatory liabilities on the consolidated balance sheets.
- (b) FBC charged the Corporation for electricity purchases and management services.
- (c) FHI charged the Corporation for Board of Director costs, management services, labour and materials.
- (d) As part of a TLUP, the Corporation paid FHI interest on \$1,400 million of inter-company subordinated debt.

## Balance Sheet Amounts

As a result of the transactions noted above, the amounts due from related parties, which are included in accounts receivable on the consolidated balance sheets, and the amounts due to related parties which are included in accounts payable and other current liabilities on the consolidated balance sheets, are as follows:

	June 30, 2014		December 31, 2013	
(\$ millions)	Amount Due From	Amount Due To	Amount Due From	Amount Due To
FEVI	2	-	2	-
FEW	1	-	1	-
FHI	-	-	2	-
FBC	-	-	-	1
	<b>3</b>	<b>-</b>	<b>5</b>	<b>1</b>

## BUSINESS RISK MANAGEMENT

The business risks of the Corporation remain substantially unchanged from those outlined in the Corporation's 2013 annual MD&A, except for the BCUC approval for the Corporation to continue using US GAAP for regulatory purposes effective January 1, 2015.

## CHANGES IN ACCOUNTING POLICIES

As applied for in the 2014 PBR Application and effective January 1, 2014, depreciation of property, plant and equipment and amortization of intangible assets commences the year after the asset is available for use. Prior to January 1, 2014, depreciation and amortization commenced in the month after the asset was available for use.

## FUTURE ACCOUNTING PRONOUNCEMENT

### Revenue from Contracts with Customers

In May 2014 the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update No. 2014-09, *Revenue from Contracts with Customers*. The amendments in this update create Accounting Standard Codification ("ASC") Topic 606, *Revenue from Contracts with Customers*, and supersede the revenue recognition requirements in ASC Topic 605, *Revenue Recognition*, including most industry-specific revenue

recognition guidance throughout the codification. This update completes a joint effort by FASB and the IASB to improve financial reporting by creating common revenue recognition guidance for US GAAP and IFRS that clarifies the principles for recognizing revenue and that can be applied consistently across various transactions, industries and capital markets. This update is effective for annual and interim periods beginning on or after December 15, 2016 and is to be applied on a full retrospective or modified retrospective basis. Early adoption is not permitted. FEI is assessing the impact that the adoption of this standard will have on its consolidated financial statements.

## FINANCIAL INSTRUMENTS

### Fair Value Estimates

The following table summarizes the fair value measurements of the Corporation's long-term debt and natural gas commodity derivative contracts as of June 30, 2014 and December 31, 2013, all of which are Level 2 of the fair value hierarchy and recorded on the consolidated balance sheet at their carrying value:

(\$ millions)	June 30, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Long-term debt	1,545	1,930	1,545	1,842
Natural gas commodity swaps and options and gas purchase contract premium <sup>1</sup>	6	6	3	3

<sup>1</sup> Included in accounts payable as at June 30, 2014 and December 31, 2013.

The fair values of the Corporation's financial instruments, including derivatives, reflect a point-in-time estimate based on current and relevant market information about the instruments as at the balance sheet dates. The estimates cannot be determined with precision as they involve uncertainties and matters of judgment.

At June 30, 2014, the Corporation's outstanding derivative balances were as follows:

(\$ millions)	Gross Derivatives Balance <sup>1</sup>	Netting <sup>2</sup>	Cash Collateral	Total Derivatives Balance
Natural gas commodity derivatives:				
Accounts payable and other current liabilities	6	-	-	6

<sup>1</sup> See the June 30, 2014 unaudited interim consolidated financial statements for a discussion of the valuation techniques used to calculate the fair value of these instruments.

<sup>2</sup> Positions, by counterparty, are netted where the intent and legal right to offset exists.

At December 31, 2013, the Corporation's outstanding derivative balances were as follows:

(\$ millions)	Gross Derivatives Balance <sup>1</sup>	Netting <sup>2</sup>	Cash Collateral	Total Derivatives Balance
Natural gas commodity derivatives:				
Accounts payable and other current liabilities	3	-	-	3

<sup>1</sup> See the December 31, 2013 consolidated financial statements for a discussion of the valuation techniques used to calculate the fair value of these instruments.

<sup>2</sup> Positions, by counterparty, are netted where the intent and legal right to offset exists.

The following table shows the cumulative unrealized losses at June 30, 2014 and December 31, 2013, with respect to the derivative instruments:

(\$ millions)	June 30, 2014	December 31, 2013
Unrealized loss on natural gas commodity derivatives <sup>1,2</sup>	6	3

<sup>1</sup> Unrealized gains and losses on commodity risk-related derivative instruments are recorded to current regulatory assets or liabilities rather than being recorded to the consolidated statement of earnings.

<sup>2</sup> These amounts are fully passed through to customers in rates. Accordingly, net earnings were not impacted by realized amounts on these instruments.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of the Corporation's interim unaudited consolidated financial statements in accordance with US GAAP requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Estimates and judgments are based on historical experience, current conditions and various other assumptions believed to be reasonable under the circumstances. Additionally, certain estimates and judgments are necessary since the regulatory environment in which the Corporation operates often requires amounts to be recorded at estimated values until these amounts are finalized pursuant to regulatory decisions or other regulatory proceedings. Due to changes in facts and circumstances and the inherent uncertainty in making estimates, actual results may differ significantly from current estimates. Estimates and judgments are reviewed periodically and, as adjustments become necessary, are recorded in the period they become known.

Interim financial statements may also employ a greater use of estimates than the annual financial statements. There were no material changes in the nature of the Corporation's critical accounting estimates year-to-date 2014 from those disclosed in the Corporation's 2013 annual MD&A.

## SUMMARY OF QUARTERLY RESULTS

The following table sets forth unaudited quarterly information for each of the eight quarters ended September 30, 2012 through June 30, 2014. The information has been obtained from the Corporation's unaudited interim consolidated financial statements which, in the opinion of management, have been prepared in accordance with US GAAP. Past operating results are not necessarily indicative of results for any future period and should not be relied upon to predict future performance.

Quarter Ended (\$ millions)	Revenue	Net Earnings (Loss)
June 30, 2014	239	4
March 31, 2014	451	69
December 31, 2013	409	47
September 30, 2013	173	(17)
June 30, 2013	200	(1)
March 31, 2013	428	75
December 31, 2012	388	46
September 30, 2012	170	(10)

Due to the seasonal nature of the Corporation's natural gas transmission and distribution operations and its impact on, natural gas consumption patterns, the natural gas transmission and distribution operations of FEI normally generate higher net earnings in the first and fourth quarters and lower net earnings in the second quarter, which are partially offset by net losses in the third quarter. As a result of the seasonality, interim earnings are not indicative of earnings on an annual basis.

**September 2013/2012** – The higher net loss was primarily due to higher operation and maintenance expense due to the timing of the expenditures, a lower allowed ROE in 2013 compared to 2012, a decrease in the equity component of the capital structure and lower margin associated with lower than forecast customer additions partially offset by higher rate base.

**December 2013/2012** – Net earnings were higher primarily due to higher margin due to the timing of the recognition of customer demand, lower than forecasted finance charges, higher rate base and a higher allowance for funds used during construction partially offset by a lower allowed ROE in 2013 compared to 2012, a decrease in the equity component of the capital structure and higher income taxes.

**March 2014/2013** - Net earnings were lower primarily due to a lower allowed ROE, a decrease in the equity component of capital structure and higher income taxes. The GCOC stage one decision reducing the allowed ROE and equity component of capital structure although effective January 1, 2013, was received in May 2013.

**June 2014/2013** – Net earnings were higher primarily due to the retroactive negative impact of the GCOC decision reflected in the second quarter of 2013 relating to the first quarter of 2013.

## **BUSINESS OUTLOOK**

### **Collective Agreements**

The collective agreement between the Corporation and Local 213 of the International Brotherhood of Electrical Workers (“IBEW”) expires on March 31, 2015. IBEW represents employees in specified occupations in the areas of transmission and distribution.

There are two collective agreements between the Corporation and Local 378 of the Canadian Office and Professional Employees Union (“COPE”). The first collective agreement representing employees in specified occupations in the areas of administration and operations support expires March 31, 2015. The second collective agreement representing customer service employees expired on March 31, 2014. The Corporation and COPE renewed this collective agreement for a three year term which expires on March 31, 2017.

### **Contingencies**

The Corporation was the plaintiff in a BC Supreme Court action against the City of Surrey (“Surrey”) in which the Corporation sought the court’s determination on the manner in which costs related to the relocation of a natural gas transmission pipeline would be shared between itself and Surrey. The relocation was required due to the development and expansion of Surrey’s transportation infrastructure. The Corporation claimed that the parties had an agreement that dealt with the allocation of costs. In turn, Surrey advanced counterclaims including an allegation that the Corporation breached the agreement and that Surrey suffered damage as a result. In December 2013, the Court issued a decision which ordered the Corporation and Surrey to share equally the cost of the pipeline relocation. The Court also decided that Surrey was successful in its counterclaim that the Corporation breached the agreement. The amount of damages which may be awarded to Surrey at a subsequent hearing cannot be reasonably determined or estimated at this time and, accordingly, no amount has been accrued in the financial statements.

## **OUTSTANDING SHARE DATA**

As at the filing date of this MD&A the Corporation had issued and outstanding 64,910,782 common shares.

The Corporation is an indirect wholly-owned subsidiary of Fortis.

## **ADDITIONAL INFORMATION**

Additional information about FortisBC Energy Inc., including its Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **For further information, please contact:**

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