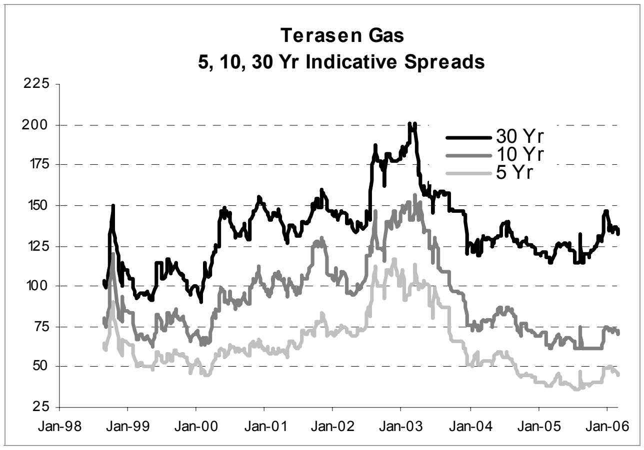
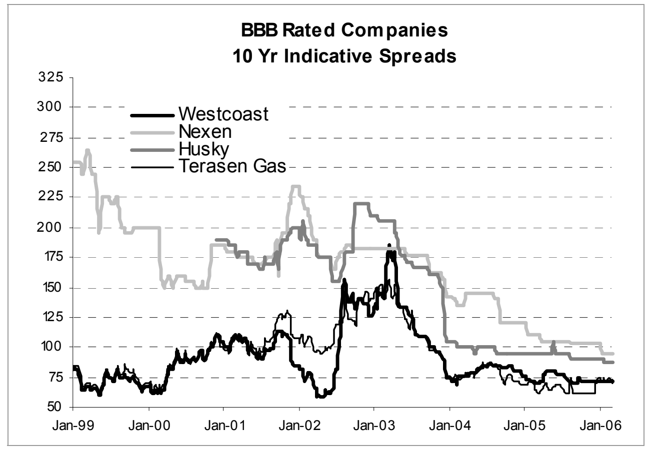
**3. Reports by investment analysts for the utility and corporate parent since 2006, where applicable:**

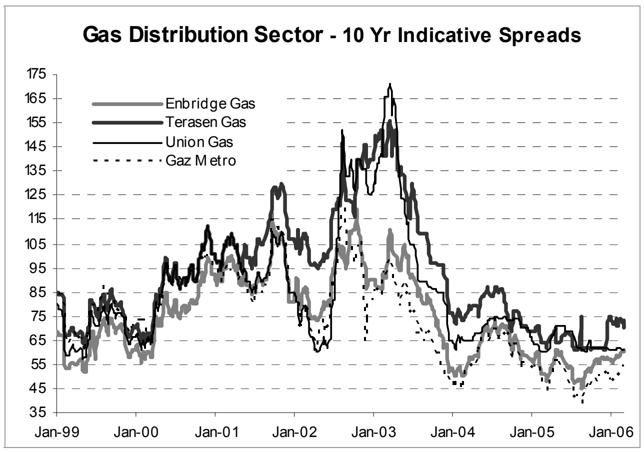
A. Enclosed are debt investment analyst reports for FEI, its parent FHI and its ultimate parent, Fortis Inc. (FTS)
   - BMO – FEI
   - Scotiabank – FEI
   - BMO – FHI
   - Scotiabank - FHI
   - RBC – FTS family

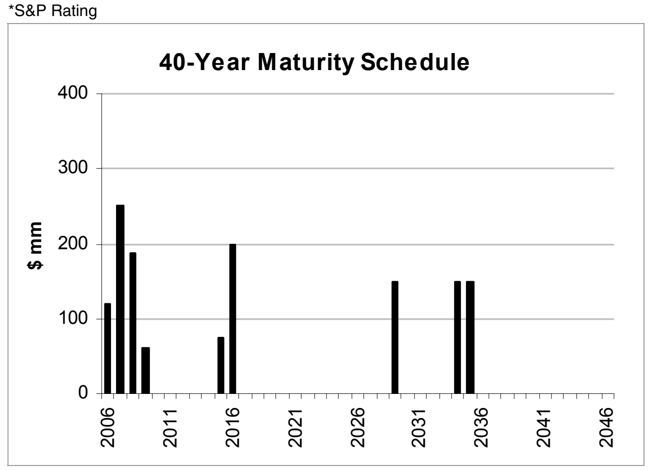
# Terasen Gas Inc.




*S&P Rating




| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | Negative | Stable |

**Disclosures:** 9, 10C

Source for Financial Estimates: BMO Nesbitt Burns' equity analyst Karen Taylor's financial model.

**Index Weighting** – Terasen Gas has a 0.22% weighting in the S&P/TSX Canadian Corporate Bond Index and a 7.29% weighting in the Utilities sector of the index.

**Company Description** – Terasen Gas transports and distributes natural gas to 792,130 residential, commercial and industrial customers in the interior and in the Greater Vancouver and Fraser Valley areas of British Columbia, representing approximately 87% of the existing natural gas users in British Columbia. Terasen Gas is a wholly owned subsidiary of Terasen Inc. Terasen Gas Vancouver Island (TGVI) and Terasen Gas (Whistler) Inc. are also owned by Terasen Inc. TGVI and Terasen Gas (Whistler) Inc. serve more than 81,000 customers on Vancouver Island, in Whistler and in the Sunshine Coast area. Terasen Gas is regulated by the British Columbia Utilities Commission (BCUC). *Website: terasengas.com*

**– Notes –**

**Analyst's Certification**

I, Sue McNamara, 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 I have not, am not, and will not receive, directly or indirectly, compensation in exchange for expressing the specific recommendations or views in this report.

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Disclosure 10: This issuer is a client (or was a client) of BMO Nesbitt Burns, HNC or an affiliate within the past 12 months: Non Securities Related Services.

**Distribution of Ratings**

| Rating Category | BMO NB Rating | BMO NB Universe | BMO NB I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 44% | 44% | 47% |
| Hold | Market Perform | 44% | 45% | 45% |
| Sell | Underperform | 13% | 11% | 9% |

* Reflects rating distribution of all companies where BMO NB has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

BMO Nesbitt Burns uses the following ratings system definitions. **OP = Outperform** - Forecast to outperform the market; **Mkt = Market Perform** - Forecast to perform roughly in line with the market; **Und = Underperform** - Forecast to underperform the market; **(S) = speculative investment**; **NR = No rating at this time** - usually due to a company being in registration or coverage being initiated.

^Market performance as measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company.

Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

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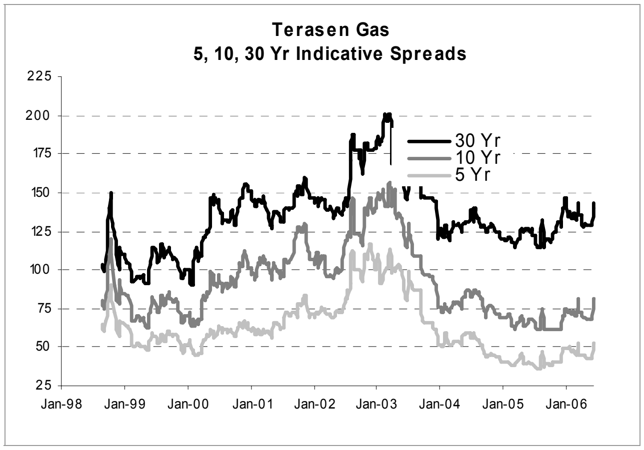
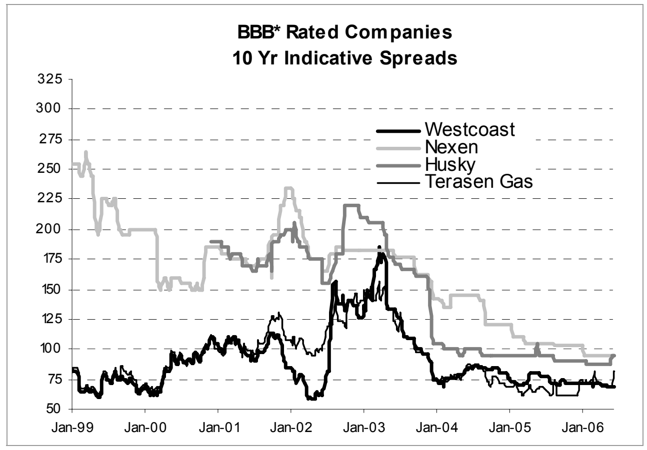
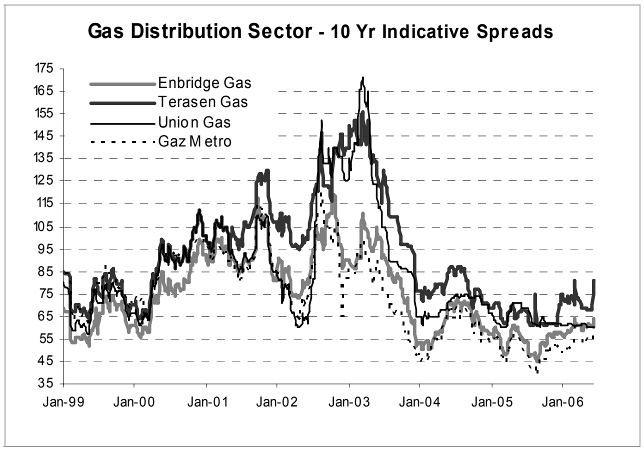
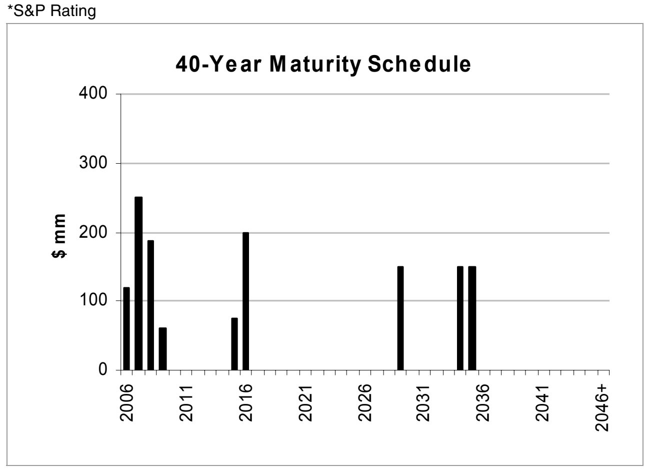



*S&P Rating




| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | CW - Negative | Stable |

**Disclosures:** 2, 3, 9, 10AC

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**Recent Results** – Reflecting what is traditionally its strongest quarter of the year, Terasen Gas reported Q1/06 net income of $48.8 million, marginally lower than the net income of $49 million recorded in Q1/05. Due to patterns of natural gas consumption in the province, higher earnings in Q1 and Q4 are generally offset by net losses in Q2 and Q3. Terasen Gas generated free cash flow (funds from operations less capital expenditure and dividends) of $49.5 million during the quarter versus negative free cash flow of $16.9 million in Q1/05. The contributing factors to the significant variance was the adverse impact of abnormally high capital expenditure in Q1/05 of $71.5 million (bolstered by the $49.4 million of the Coastal Facilities buildings) compared to what is more typical of quarterly capital expenditures of $18.7 million in Q1/06, and the absence of a dividend in Q1/06 compared to dividend payment of $15 million in Q1/05.

**Corporate Developments** – Developments in the first half of 2006 have included a reasonably supportive regulatory decision, and an ownership issue with potential negative implications for the company's credit quality.

On March 2, 2006, the provincial regulator, the BCUC, issued a decision on Terasen Gas's 2006 rate application. The decision included an allowed return on equity of 8.8%, which, although lower than the 9.03% allowed in 2005, was 51 basis points higher than was expected for 2006 based on the regulator's bond yield-linked ROE formula. In addition, following an application by the company, the BCUC also marginally increased the deemed equity component in Teresan Gas' capital structure for regulatory purposes to 35% from 33%, but not to the full extent of the company's requested layer of 38%. The BCUC's decision is effective as of January 2006.

A more recent development that will take some months to play out is the announced management buyout of Terasen Gas' ultimate owner, Kinder Morgan Inc. The proposal from a group of investors led by Richard D. Kinder, Chairman and CEO of the company on May 29, 2006, to acquire all of the outstanding shares of Kinder Morgan Inc. has potential implications for Terasen Gas and its immediate owner Terasen Inc. The implications included a lowering of Terasen Gas' credit quality as the credit strength of Kinder Morgan declines, possibly into 'BB' territory (as debt is used to partly finance the proposed buyout), and or the unknown influence of a new owner should Terasen Gas Inc. be sold as mooted.

**Capitalization and Liquidity** – Terasen Gas had total debt outstanding of $1.54 billion as of March 31, 2006, comprising $1.23 billion of long-term debt, $122.3 million of current long-term debt and $187 million in short-term notes. Maturing debt in 2006 includes $100 million 6.15% Series 16 MTN due July 31, 2006, followed by a $20 million 9.75% Series D MTN issue due December 17, 2006. Terasen Gas replaced its expired shelf filing (January 2006) with a new $700 million shelf in early December 2005. The shelf program is valid until January 2008. As of March 31, 2006, the entire amount of the shelf was available. The company made no debt issues in Q1/06. Terasen Gas has lines of credit of $500 million, of which $223 million was utilized for short-term borrowings (mostly commercial paper and banker' acceptances) and letters of credit, leaving $277 million available as of quarter-end. The company had a minimal cash balance of $2.7 million at quarter-end. The company has estimated capital expenditures in 2006, which are to be largely debt financed, of $119 million. At the end of Q1/06, lower short-term debt contributed to a modest decline in the company's total debt to total capitalization based on reported results to 63.2% from 66.3% at year-end 2005.

**Credit Ratings** – Terasen Gas' senior unsecured debt is rated A, BBB, and A3 by DBRS, Standard and Poor's, and Moody's, respectively. DBRS has a Stable trend on the rating, and Moody's a Stable outlook. Following the announcement of the proposed management buyout of Kinder Morgan Inc. on May 29, 2006, Standard & Poor's placed its ratings on Terasen Gas Inc. on CreditWatch with Negative Implications. The rating action reflects the agency's view that the ring-fencing measures adopted by Terasen Gas Inc., as part of the sale of Terasen Inc. to Kinder Morgan in 2005, are ineffective in protecting the utility from the creditworthiness of its immediate and ultimate parents, Terasen Inc. and Kinder Morgan, respectively.

The ratings assigned to the debt of Terasen Gas Inc. by DBRS and Moody's largely reflect the utility's stand-alone creditworthiness. For Standard & Poor's, however, the rating on Terasen Gas reflects the consolidated credit profile of Terasen Inc., and the wider Kinder Morgan Inc. group. Consistent with the agency's consolidated rating methodology, core subsidiaries receive the same long-term corporate credit rating as the parent company, reflecting the same level of default risk.

DBRS confirmed its A senior unsecured debt rating on Terasen Gas on May 30, 2006, following the announced management buyout at Kinder Morgan. While the agency placed the ratings of Kinder Morgan Under Review with Negative Implications due to the estimated pro forma debt to capital increase and impact on other credit ratios. DBRS' view is that the financial profile of Terasen Gas is not expected to be impacted at all. DBRS takes comfort in the regulatory ring-fencing imposed by the BCUC as a condition of the acquisition by Kinder Morgan of Terasen Inc. in December 2005, which required, among other items, the maintenance of the BCUC-approved capital structure; no common dividend payment without BCUC approval if the payment would violate the approve capital structure; no financial support or guarantees for non-regulated businesses; and no transactions with affiliates that would violate BCUC guidelines, policies, or directives. The intent of the BCUC decision, among other things, was to ensure that Terasen Gas operates as a separate, stand-alone entity without parental influence.

Standard & Poor's ratings on Terasen Gas Inc. reflect the consolidated credit profile of the parent company, Terasen Inc., and ultimate parent Kinder Morgan Inc. On a stand-alone basis, the credit profile of Terasen Inc. reflects the company's low-risk, regulated gas distribution business and stable liquids pipelines business. These strengths are partially offset by Terasen's below average consolidated financial profile. Prior to the recent CreditWatch listing, Standard & Poor's had a Negative outlook on Kinder Morgan Inc. and its British-Columbia-based subsidiaries, reflecting the considerable challenges faced by Kinder Morgan Inc. as it works to integrate the Terasen assets and business operations into its corporate culture and systems of Kinder Morgan Inc. at a time when Kinder Morgan Inc.'s financial position is stretched.

Moody's reaction to the proposed Kinder Morgan management buyout was to affirm Terasen Gas Inc.'s A3 senior unsecured rating and Stable outlook on May 30, 2006. Terasen Inc.'s ratings were placed Under Review for downgrade in concert with Kinder Morgan's, because Kinder Morgan guarantees the acquisition debt raised to acquire Terasen Inc. Terasen Gas's ratings are affirmed because of the protections provided by the ring-fencing provisions in the BCUC's order approving the company's merger with Kinder Morgan.

**Debt Recommendation –** Year-to-date 2006, the company's 5- and 10-year generic credit spreads have widened by 4 and 6 basis points, respectively, while the 30-year generic credit spreads have narrowed by 4 basis points. The issue for Terasen Gas' spreads will be the degree to which investors remain comfortable with the ring-fencing measures adopted to distance Terasen Gas from the credit quality of Terasen Inc. and Kinder Morgan Inc. Standard & Poor's view is that the ring-fencing measures are not adequate. Regardless of the adequacy of the ring-fencing, the proposed management buyout of Kinder Morgan Inc. heightens event risk surrounding the credit. With Terasen Gas Inc.'s sister company, Terasen Pipelines Inc., the primary strategic rationale for Kinder Morgan Inc.'s purchase of Terasen Inc. in 2005, we believe a sale of Terasen Gas is a distinct possibility, especially if the proposed management buyout of Kinder Morgan proceeds as planned.

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 6.150% | 31-Jul-06 | $100 | MTNs | 30-Jul-01 | 73.0 bps | Make Whole + 18 bps | 88079ZAL0 | $100 |
| Terasen Gas Inc. | 9.750% | 17-Dec-06 | $20 | Retractable Debentures | 17-Dec-86 | NA | Non-callable | NA | $20 |
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | Floating | 24-Oct-07 | $150 | Floating Rate Notes | 24-Oct-05 | NA | Non-callable | 88078ZAD6 | $150 |
| Terasen Gas Inc. | 6.200% | 02-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Gas Inc. | 10.750% | 08-Jun-09 | $60 | Debentures | 08-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |

## Ownership Structure

100% - Terasen Inc.

## Credit Facilities

| Company | Facility Size | Amount Available Q1/06 | Amount Available FY 2005 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $277 | $151 | | Lines of Credit |

## Corp. Lease Schedule (12/31/2005)

| Year | Capital Lease Payments ($mm) | Operating Payments | Lease Receipts |
|---|---|---|---|
| 2006 | | 16.4 | |
| 2007 | | 16.0 | |
| 2008 | | 16.4 | |
| 2009 | | 16.3 | |
| 2010 | | 16.0 | |
| Thereafter | | 124.6 | |

## Shelf Prospectus

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $700 | 08-Dec-05 | 08-Jan-08 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2005 ($mm) | Pension Benefit Plans FY 2004 ($mm) | Other Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2004 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 213.7 | 191.7 | 64.3 | 52.9 |
| Plan Assets | 202.4 | 185.2 | - | - |
| Funded Status | (11.3) | (6.5) | (64.3) | (52.9) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 4.8 | 4.4 | (31.1) | (24.3) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation* | 3.36% | 3.33% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | Trend | Date | S&P Rating | Trend | Date | Moody's Rating | Trend | Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | BBB | Credit Watch Negative | 30-May-06 | A3 | Stable | 19-Dec-05 |
| | | | BBB | Negative | 06-Dec-05 | A2 | Under Review - Negative | 02-Aug-05 |
| | | | BBB | Credit Watch Negative | 02-Aug-05 | A2 | Stable | 12-Dec-02 |
| | | | BBB | Stable | 26-Jun-03 | A2 | Under Review - Negative | 19-Nov-02 |
| | | | BBB+ | Credit Watch Negative | 19-Nov-02 | A2 | Stable | 07-Nov-01 |
| | | | BBB+ | Stable | 08-May-01 | | | |

– Notes –

### Analyst's Certification

I, Laurie Conheady, 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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| Sell | Underperform | 10% | 4% | 7% |

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Flash

BMO Capital Markets | Canada

# Terasen Gas Inc.

**August 10, 2006**
Brief Research Note
Corporate Debt – Gas & Electric Utilities

**Laurie Conheady**
(416)-359-4584
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## S&P Says Rating on Terasen Gas Inc. to Remain Investment Grade

### Impact

Positive

### Details & Analysis

Standard & Poor's has indicated that the rating on Tereasn Gas Inc. would remain investment grade even if the ratings on the utility's ultimate U.S. parent, Kinder Morgan Inc., fell to sub-investment grade as a consequence of the proposed management buyout of that company. The CreditWatch Negative means the rating will either stay at its current level of BBB, or possibly go a notch lower to BBB-. The retention of a CreditWatch on Terasen Gas reflects the possibility the rating could be downgraded from its current level, depending on the ultimate outcome and parameters of the buyout offer. In an update of its CreditWatch on the B.C.-based gas distributor on August 10, 2006, and accompanying article, "Credit FAQ: Terasen Gas Inc. To Remain Investment Grade," Standard & Poor's indicated that it believes a degree of rating insulation is provided by the likely action of the British Columbia Utilities Commission, who would be expected to intercede to prevent the deterioration of Terasen Gas's credit quality to below the investment-grade level. The rating agency also takes comfort in the actions of Kinder Morgan's management since its acquisition of the gas distributor, which has been consistent with maintaining the utility's investment grade credit quality. The ratings on Tersaen Gas' Canadian parent, Terasen Inc., remain on CreditWatch Negative. Unlike its regulated subsidiary, however, we expect the ratings on Terasen to follow those on Kinder Morgan into the 'BB' territory should the Kinder Morgan management buyout proceed as planned. The rating action undertaken by Standard & Poor's is not a complete surprise, as we had foreshadowed such a possibility in our article, "Utility Opco Debt Still Favoured Over Holdco Debt," published in our *Weekly Credit Edge* of August 8, 2006.

### Senior Unsecured Debt Ratings

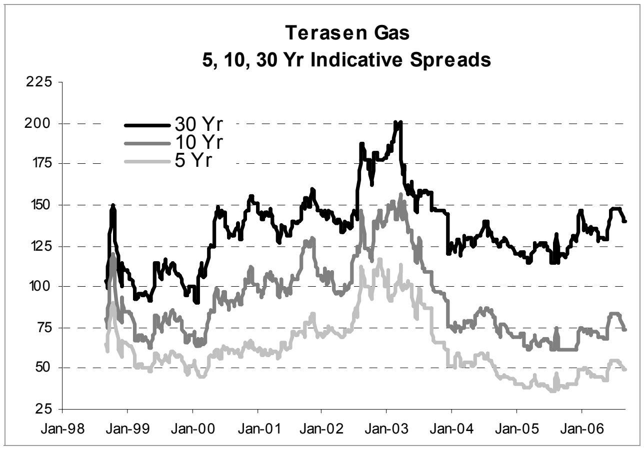
| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | CW-Neg | Stable |

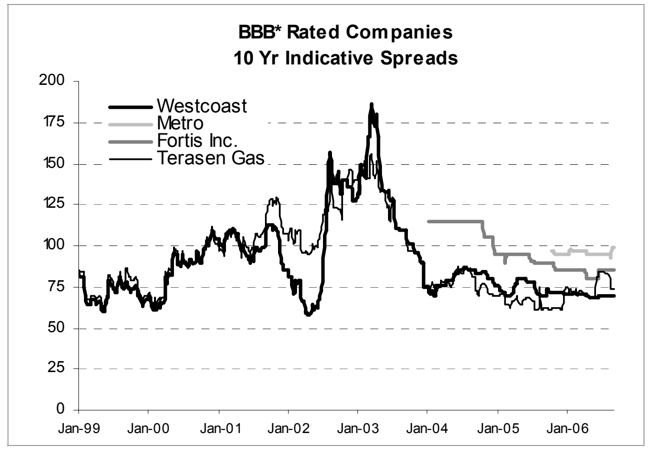
**This report was prepared by an Analyst employed by a Canadian affiliate, BMO Nesbitt Burns Inc., and who is not registered/qualified as a research analyst under NYSE/NASD rules. For disclosure statements, including the Analyst's Certification, please refer to page 2.**

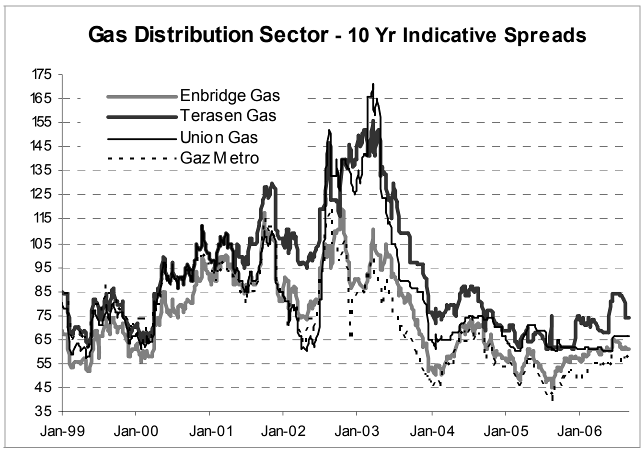
## Analyst's Certification

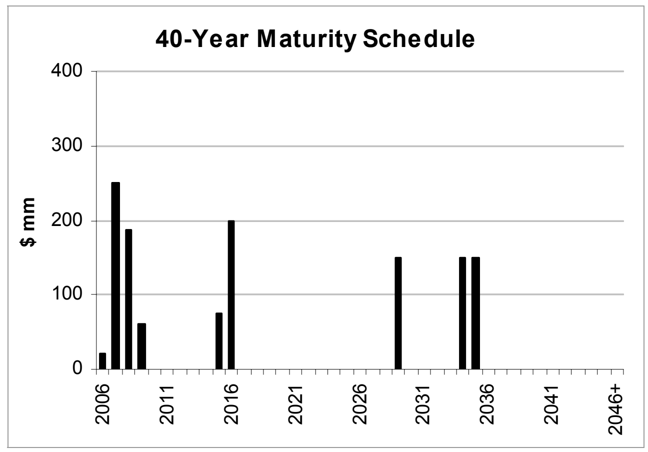
I, Laurie Conheady, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed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

# Terasen Gas Inc.




| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | CW - Negative | Stable |

**Disclosures:** 2, 3, 9, 10AC

**Index Weighting** – Terasen Gas Inc. has a 0.22% weighting in the S&P/TSX Canadian Corporate Bond Index and a 6.87% weighting in the Utilities sector of the index.

**Company Description** – Terasen Gas transports and distributes natural gas to 125 communities across British Columbia. Terasen Gas is a subsidiary of Terasen Inc., which is in turn wholly owned by Kinder Morgan Inc. (KMI). The British Columbia Utilities Commission (BCUC) regulates Terasen Gas. Website*: www.terasengas.com*

**Recent Results** – Terasen Gas recorded a $6.1 million loss in Q2/06 versus a $1.6 million profit in Q2/05. Funds from operations in Q2/06 were insufficient to meet $22.8 million in capital expenditure. No dividends were paid in the quarter.

**Corporate Developments** – On August 14, the BCUC approved the opening of a portion of the residential natural gas market to competition. On August 28, KMI announced a definitive agreement, under which KMI would be acquired by way of a management buyout. On August 30, the IBEW accepted terms of a new five-year contract with Terasen Gas.

**Capitalization and Liquidity** – Reflecting lower short-term debt, Terasen Gas's total debt outstanding of $1.48 billion in Q2/06 was $190 million lower than at Dec. 31, 2005. Total debt to total capital was 62% down from 66.3% at year-end 2005. The company's liquidity is supported by a $500 million credit facility, which at June 30, 2006, had $332 million of available capacity, and an unused $700 million shelf program.

**Credit Ratings** – Standard & Poor's placed its ratings on Terasen Gas on CreditWatch with Negative Implications, following the announced management buyout of KMI on May 30, 2006. Of significance for spreads was the agency's subsequent decision on August 10, 2006, to permit a partial de-linking of the ratings between KMI and Terasen Gas to the extent that the rating on Terasen Gas would remain investment grade should KMI's rating fall below BBB-. DBRS affirmed its rating on Terasen Gas on August 28, 2006.

**Debt Recommendation** – After narrowing the most of any utility in the past quarter, Terasen Gas' spreads are now tighter than they were in January. Year-to-date 2006, the company's 5-year generic credit spread is unchanged, while its 10-and 30-year generic spreads have narrowed by 2 and 9 basis points, respectively. The tightening spreads have in no small part likely been influenced by the increasing confidence of investors that the rating will not move to sub-investment grade.

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 9.750% | 17-Dec-06 | $20 | Retractable Debentures | 17-Dec-86 | NA | Non-callable | NA | $20 |
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | Floating | 24-Oct-07 | $150 | Floating Rate Notes | 24-Oct-05 | NA | Non-callable | 88078ZAD6 | $150 |
| Terasen Gas Inc. | 6.200% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |

## Ownership Structure

100% - Terasen Inc.

## Corp. Lease Schedule (12/31/2005)

| Year | Capital Lease Payments ($mm) | Operating Payments | Lease Receipts |
|---|---|---|---|
| 2006 | | 16.4 | |
| 2007 | | 16.0 | |
| 2008 | | 16.4 | |
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| Thereafter | | 124.6 | |

## Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q2/06 | Amount Available FY 2005 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $332 | $151 | Jun-09 | Extendable 3-year revolving credit facility |

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $700 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2005 ($mm) | Pension Benefit Plans FY 2004 ($mm) | Other Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2004 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 213.7 | 191.7 | 64.3 | 52.9 |
| Plan Assets | 202.4 | 185.2 | - | - |
| Funded Status | (11.3) | (6.5) | (64.3) | (52.9) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 4.8 | 4.4 | (31.1) | (24.3) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation* | 3.36% | 3.33% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | Trend | Date | S&P Rating | Trend | Date | Moody's Rating | Trend | Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | BBB | CreditWatch Negative | 30-May-06 | A3 | Stable | 19-Dec-05 |
| | | | BBB | Negative | 6-Dec-05 | A2 | Under Review - Negative | 2-Aug-05 |
| | | | BBB | CreditWatch Negative | 2-Aug-05 | A2 | Stable | 12-Dec-02 |
| | | | BBB | Stable | 26-Jun-03 | A2 | Under Review - Negative | 19-Nov-02 |
| | | | BBB+ | CreditWatch Negative | 19-Nov-02 | A2 | Stable | 7-Nov-01 |
| | | | BBB+ | Stable | 8-May-01 | | | |

### Analyst's Certification

I, Laurie Conheady, 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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Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Investment Banking Services & Non-Securities Related Services.

### Distribution of Ratings

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 38% | 47% | 49% |
| Hold | Market Perform | 53% | 47% | 45% |
| Sell | Underperform | 9% | 6% | 6% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

### Ratings Key

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;

R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

**Dissemination of Research**

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

**Additional Matters**

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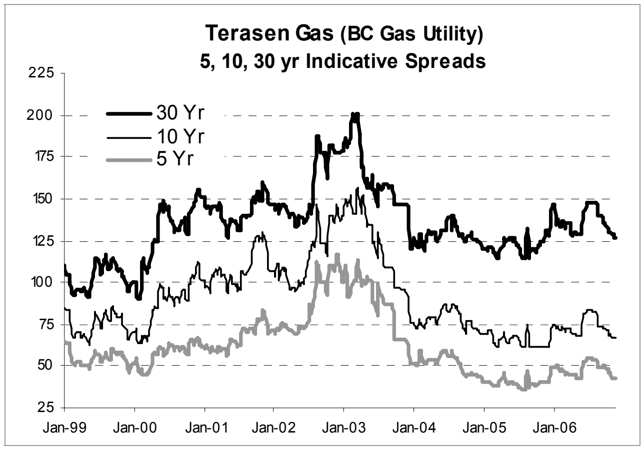
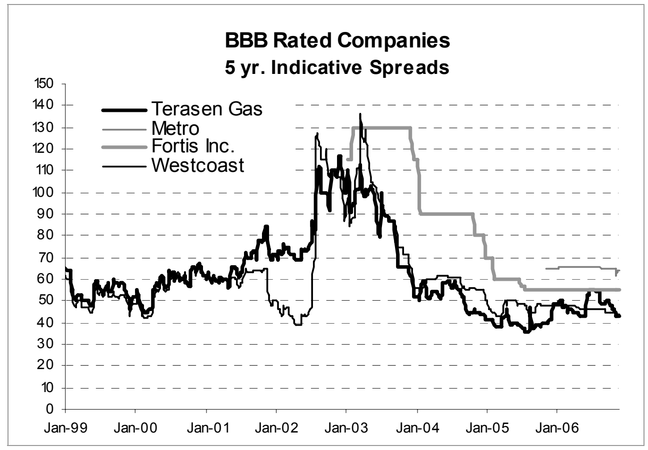
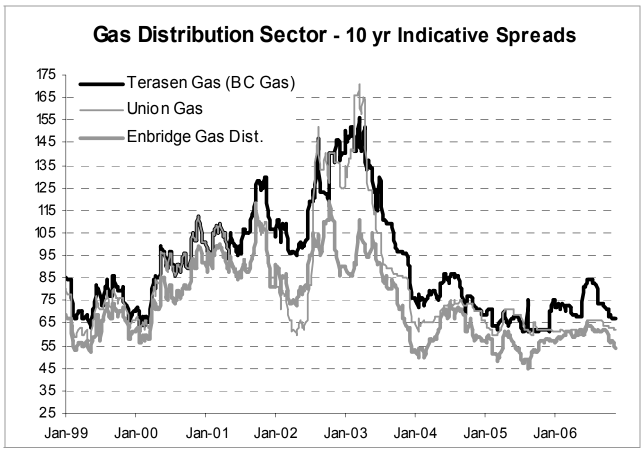
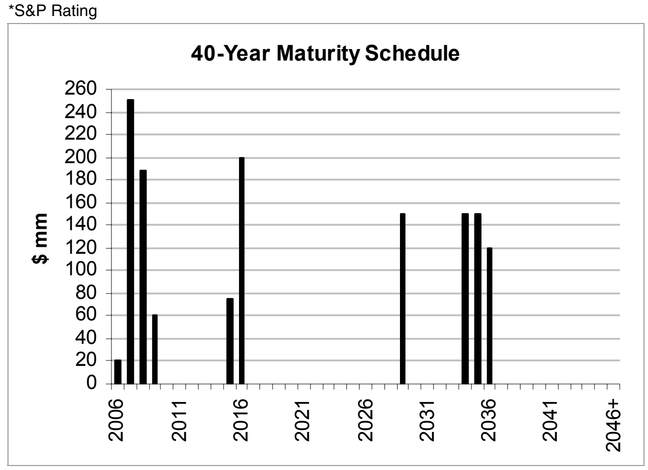



*S&P Rating




Source: Bloomberg

| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | CW - Negative | Stable |

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**Recent Results** – Reflecting its low earnings season, Terasen Gas recorded a $13.5 million loss in Q3/06 versus a loss of $9.7 million in Q3/05. Not unexpectedly, lower FFO of $9.1 million in Q3/06 was insufficient to fund $28.7 million in capital expenditure, with debt making up the shortfall. No dividends were paid in Q3/06.

**Corporate Developments** – In recent filings with the SEC, KMI has indicated possible divestitures of Canadian assets, including Terasen Gas, on completing the management buyout.

On Nov. 23, 2006, the BCUC released its return on common equity for a low-risk benchmark utility for the year 2007 and, not surprisingly, the ROE is lower. The return of 8.37% for 2007 will apply to Terasen Gas. It compares to 8.80% in 2006.

**Capitalization and Liquidity** – Terasen Gas's total debt of $1.58 billion in Q3/06 was $87 million lower than at Dec. 31, 2005. Year-end is the peak of seasonal borrowings. Leverage was 64%, marginally lower than year-end 2005 leverage of 66%. At Sept. 30, 2006, the utility had $249 million available under its credit facility, and $580 million of capacity under its MTN shelf program following a $120 million issue in Q3/06 to repay maturity debt and retire a debenture due in Q4/06.

**Credit Ratings** –Standard & Poor's has its ratings on Terasen Gas on CreditWatch with Negative Implications, as a result of the proposed KMI management buyout. On Aug. 10, 2006, the agency announced a partial de-linking of the ratings between KMI and Terasen Gas to the extent the rating on Terasen Gas would remain investment grade should KMI's rating fall below BBB-. DBRS affirmed its rating on Terasen Gas on Aug. 28, 2006, and Moody's affirmed its rating on Nov. 14, 2006.

**Debt Recommendation** – After a rollercoaster ride during the year, Terasen Gas' spreads are now tighter than they were in January. Year-to-date 2006, the utility's 5-, 10- and 30-year generic spreads are tighter by 6, 8 and 20 basis points, respectively. With uncertainty about future ownership and the CreditWatch Negative outcome, we remain wary about material narrowing of spreads beyond the recent movement.

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
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| Terasen Gas Inc. | 5.550% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole + 34 bps | 88078ZAE4 | $120 |

## Ownership Structure

100% - Terasen Inc.

### Corp. Lease Schedule (12/31/2005)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
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| 2006 | | 16.4 | |
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### Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q3/06 | Amount Available FY 2005 | Maturity | Type |
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| Terasen Gas Inc. | $500 | $249 | $151 | Jun-09 | Extendable 3-year revolving credit facility |

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $580 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2005 ($mm) | Pension Benefit Plans FY 2004 ($mm) | Other Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2004 ($mm) |
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| Accrued Benefit Obligation | 213.7 | 191.7 | 64.3 | 52.9 |
| Plan Assets | 202.4 | 185.2 | - | - |
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| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 4.8 | 4.4 | (31.1) | (24.3) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation* | 3.36% | 3.33% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | Trend | Date | S&P Rating | Trend | Date | Moody's Rating | Trend | Date |
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| A | Stable | 23-Aug-99 | BBB | CreditWatch Negative | 30-May-06 | A3 | Stable | 19-Dec-05 |
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| | | | BBB | Stable | 26-Jun-03 | A2 | Under Review - Negative | 19-Nov-02 |
| | | | BBB+ | CreditWatch Negative | 19-Nov-02 | A2 | Stable | 7-Nov-01 |
| | | | BBB+ | Stable | 8-May-01 | | | |

**Analyst's Certification**

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| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 35% | 45% | 47% |
| Hold | Market Perform | 55% | 48% | 46% |
| Sell | Underperform | 10% | 7% | 7% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.

** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
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Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

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# Terasen Inc./Terasen Gas Inc.

**February 27, 2007**
Brief Research Note

**Laurie Conheady**
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laurence.conheady@bmo.com

## Rating Actions as Terasen Inc. and Terasen Gas are Acquired by Fortis Inc.

### Impact

Positive

### Details & Analysis

Kinder Morgan Inc. has announced a definitive agreement to sell its British Columbia-based holding company, Terasen Inc. to Fortis Inc. The acquisition includes Terasen Inc.'s principal regulated gas utility, Terasen Gas Inc. but excludes the holding company's petroleum transportation assets. We believe the acquisition is positive for the credit quality and spreads of Terasen Inc. and Terasen Gas Inc. as the transaction removes the negative impact on its credit profile of a lower rated owner in Kinder Morgan Inc. We note Standard & Poor's has moved to place its ratings on Fortis Inc., Terasen Inc. and Terasen Gas Inc. on CreditWatch with positive implications and has also advised that it is opening the door to a possible modest rating separation between Fortis and the ring-fenced Terasen Gas Inc. At the very least we expect the Standard & Poor's corporate credit rating on Terasen Inc. to be equalized with the agency's rating on Fortis Inc. (BBB+/CW-Pos/--) as there are no structural, regulatory or legal ring-fencing measures to separate the two companies' ratings. DBRS moved to confirm its rating on Terasen Gas Inc. and has placed its rating on Terasen Inc. Under Review with Developing implications due to the new owner's strong credit profile. At the time of publication, Moody's had yet to take rating action. Since the management buyout of Kinder Morgan Inc. was announced in May 2006 the 5- and 10-year indicative credit spreads on Terasen Inc. have widened significantly as the credit quality of Kinder Morgan Inc. has declined, and it is these spreads that are likely to tighten the most as a result of the new ownership. Expected close of the transaction is mid 2007 and we are currently restricted on Fortis Inc.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BB- | Baa2 |
| UR-Developing | CW-Positive | UR-Negative |

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**Analyst's Certification**

I, Laurie Conheady, 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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# Terasen Gas Inc.



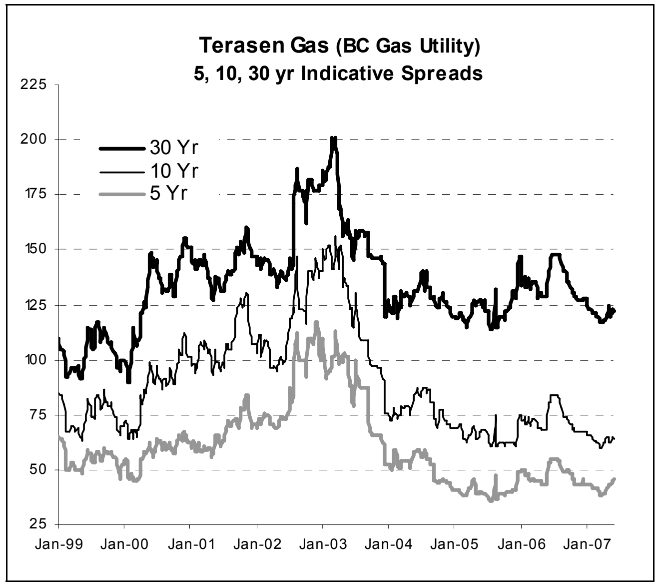
## Relative Value

**Recommendation –** We believe Fortis' acquisition of Terasen and its wholly owned gas utility, Terasen Gas Inc., is positive for the credit quality and spreads of both companies. The risks and uncertainties evident under the previous ownership are no longer a concern for bondholders, positive rating actions are expected, and bond valuations for both companies are expected to improve to move in line with its sector peers.

**Sector Value –** Relative to gas distributor peers, the spreads of Terasen Gas, particularly in the long end, look to offer value.

**Credit Curve –** After exhibiting a narrowing trend in the past year, the indicative spreads of Terasen Gas have widened in recent weeks, despite the reduced credit concerns and possible rating upgrade. The widening is more pronounced in the long end to the point that spreads relative to those in the short and mid-parts of the issuer's curve look to offer better value.

**Cash versus CDS –** There is currently no CDS market for Terasen Gas' outstanding capital market issues.




Source: BMO Capital Markets

## Risks

**External –** We do not view political risk in British Columbia as a material credit concern for Terasen Gas. The government has not exhibited a tendency to intervene in regulatory determinations.

**LBO and M&A –** As a regulated operating subsidiary of Fortis Inc., Terasen Gas is not a LBO target. Further, although it cannot be completely ruled out, a LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base. In addition, having recently acquired the utility, we do not envisage Fortis would look to divest Terasen Gas in the near term. Moreover, we expect the focus of Terasen Gas in the near term will be on the integration with its new owner and not on M&A activity.

**Regulatory –** The performance-based regulatory regime under which Terasen Gas operates is a positive feature of its business risk profile. Although continued low ROE is expected, the relatively transparent regulatory regime of the British Columbia Utilities Commission (BCUC) is not expected to present a major risk to the utility's credit profile. Further, in May 2007, the BCUC announced it had approved a two-year extension of the 2004–2007 Multi-Year Performance-Based Rate Plan currently in place for Terasen Gas. The demonstrated ability of Fortis to build good regulatory relationships also reduces regulatory risk for Terasen Gas.

**Trading Liquidity –** The liquidity of Terasen Gas' debt issues is moderate, with the issuer's debt trading on an occasional basis. The utility's $1.34 billion of capital market issues are essentially located at the short or long end of the curve.

**New Issuance –** We expect Terasen Gas to be in the market in 2007. The utility has two maturing debt issues totalling $250 million in October, which we expect will be refinanced. Further, the potential exists for a portion of the utility's short-term borrowings ($213 million at the end of Q1/07) to be refinanced with capital market issues in line with the approach generally followed by the regulated subsidiaries of Fortis in financing their longer-term rate base assets with long-dated debt.

## Credit Profile

**Company Financials –** The earnings of Terasen Gas in Q1/07 of $46.8 million were down from $48.8 million in Q1/06 primarily due to a lower rate base and a lower ROE of 8.37% compared to 8.8% applicable in 2006. FFO was, however, marginally higher and liquidity was adequate with unused bank lines of $320 million at quarter-end. Leverage in Q1/07 of 62% was down a percent versus year-end 2006.

**Company Fundamentals –** The credit profile of Terasen Gas is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex –** Terasen Gas has estimated total consolidated capital expenditures of $126 million in 2007, up from the $109 million undertaken in 2006.

**Credit Ratings –** The only rating of Terasen Gas' that is currently in play is the one assigned by Standard & Poor's. We believe the rating is likely to move higher regardless of whether the agency views Terasen Gas' regulatory ring-fencing measures as adequate. If the agency considers the ring-fencing as adequate in limiting the creditworthiness of the subsidiary to its stand-alone credit profile, the rating is expected to move higher than its current rating, although a possible impediment is the utility's low cash flow credit metrics. If, on the other hand, the rating were based more on the rating on Fortis, the rating on Terasen Gas would move higher to be equalized with its ultimate and higher-rated parent. DBRS confirmed its rating on Terasen Gas on February 26, 2007, following the announced sale of Terasen to Fortis. Moody's last confirmed its rating on Terasen Gas on November 14, 2006.

| DBRS | S&P | Moody's |
|---|---|---|
| A | BBB | A3 |
| Stable | CW-Pos | Stable |

**Disclosures:** 2, 3, 7, 9, 10AC

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | Floating | 24-Oct-07 | $150 | Floating Rate Notes | 24-Oct-05 | NA | Non-callable | 88078ZAD6 | $150 |
| Terasen Gas Inc. | 6.200% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.550% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole + 34 bps | 88078ZAE4 | $120 |

## Ownership Structure

100% - Terasen Inc.

### Corp. Lease Schedule (12/31/2006)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2007 | | 15.5 | |
| 2008 | | 15.6 | |
| 2009 | | 15.2 | |
| 2010 | | 14.8 | |
| 2011 | | 14.5 | |
| Thereafter | | 107.6 | |

### Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q1/07 | Amount Available FY 2006 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $320 | $261 | Jun-09 | Extendable 3-year revolving credit facility |

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $580 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2006 ($mm) | Pension Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2005 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 227.3 | 213.7 | 68.2 | 64.3 |
| Plan Assets | 228.9 | 202.4 | - | - |
| Funded Status | 1.6 | (11.3) | (68.2) | (64.3) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 7.6 | 4.8 | (38.3) | (31.1) |
| Discount Rate | 5.00% | 6.00% | 5.00% | 6.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation* | 3.64% | 3.36% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | Trend | Date | S&P Rating | Trend | Date | Moody's Rating | Trend | Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | BBB | CreditWatch Positive | 26-Feb-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CreditWatch Negative | 30-May-06 | A2 | Under Review - Negative | 2-Aug-05 |
| | | | BBB | Negative | 6-Dec-05 | A2 | Stable | 12-Dec-02 |
| | | | BBB | CreditWatch Negative | 2-Aug-05 | A2 | Under Review - Negative | 19-Nov-02 |
| | | | BBB | Stable | 26-Jun-03 | A2 | Stable | 7-Nov-01 |
| | | | BBB+ | CreditWatch Negative | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 8-May-01 | | | |

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I, Laurie Conheady, 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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**Distribution of Ratings**

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| Sell | Underperform | 10% | 8% | 7% |

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# Terasen Gas Inc.

**June 19, 2007**
Brief Research Note

**Laurie Conheady**
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laurence.conheady@bmo.com

## Standard & Poor's Upgrades Rating on Terasen Gas Inc.

### Impact

Positive.

### Details & Analysis

Standard & Poor's today upgraded its rating on Terasen Gas Inc. three notches to A from BBB and has assigned a Stable outlook. The rating was also removed from CreditWatch with Positive Implications, where it was placed on February 26, 2007, on the announced acquisition of its immediate parent, Terasen Inc., by Fortis Inc. The rating action is not surprising given the new ownership but it is fair to say the rating upgrade is higher than we expected. We believe the rating upgrade is positive for the spreads on Terasen Gas Inc. The utility's current spreads are wide relative to peers, particularly in the long end, and with the upgrade of its Standard & Poor's rating to a level generally higher than its peers, the spreads are expected to move to reflect this. Further, the rating action also removes an element of uncertainty that has plagued the rating for some time. The utility now has Stable outlooks from all three rating agencies.

We note Standard & Poor's has assigned the rating on the basis of Terasen Gas Inc.'s stand-alone credit quality. The upgrade primarily reflects the agency's view that the regulatory insulation between Terasen Gas and parent Terasen Inc. is sufficient to separate the ratings and rate Terasen Gas primarily on a basis that reflects its stand-alone credit quality instead of that of its direct parent or its indirect parent, Fortis Inc. The rating on the gas utility reflects its low-risk, regulated natural gas distribution business; its sound operational record; and its free cash generation capability. Somewhat high leverage levels partially offset these strengths. We note the agency does not see the likelihood of further ratings improvement given that an improvement in its capital structure appears remote.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| A | A | A3 |
| Stable | Stable | Stable |

**Analyst's Certification**

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**Additional Matters**

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TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltée/Ltd. are Members of CIPF. BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. are Members of SIPC.

## Relative Value

**Recommendation –** We continue to believe Fortis' acquisition of Terasen and its wholly owned gas utility, Terasen Gas Inc., is positive for the credit quality and spreads of both companies. The risks and uncertainties evident under the previous ownership are no longer a concern for bondholders and, as expected, positive rating actions have occurred, and the bond valuations for both companies have moved more in line with sector peers.

**Sector Value –** Relative to its gas utility peers, Terasen Gas' indicative spreads generally trade in line or marginally wider. We believe that given its higher and stable ratings and no adverse parental influence, the wider spreads offer a better opportunity for investors looking for exposure to Canadian gas distributors. We still believe the utility's new ownership and ring-fencing measures are positive distinguishing features relative to peers.

**Credit Curve –**Terasen Gas' spreads trade tight compared to similarly rated issuers. Nonetheless, compared to those of its peers, the utility's spreads, particularly in the long end, look to offer the best relative value.

**Cash versus CDS –** There is currently no CDS market for the outstanding capital market issues of Terasen Gas.

## Risks

**External –** We do not view political risk in British Columbia as a material credit concern for Terasen Gas. The government has not exhibited a tendency to intervene in regulatory determinations.

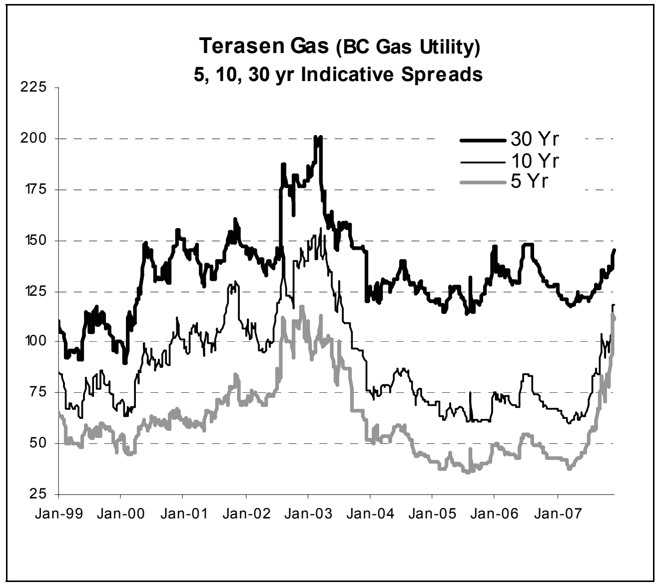
**LBO –** As a regulated operating subsidiary of Fortis Inc., Terasen Gas is not a LBO target. Further, although it cannot be completely ruled out, a LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A –** Having recently acquired the utility, we do not believe Fortis would look to divest Terasen Gas in the near term. Moreover, we expect Terasen Gas' focus will be on the integration with its new owner and not on M&A.

**Regulatory –** The performance-based regulatory regime under which Terasen Gas operates is a positive feature of its business risk profile. Although low allowed ROE is expected to continue, the relatively transparent regulatory regime of the British Columbia Utilities Commission (BCUC) is not expected to present a major risk to the utility's credit profile. Further, in May 2007, the BCUC announced it had approved a two-year extension of the 2004–2007 Multi-Year Performance-Based Rate Plan currently in place for Terasen Gas. Fortis' demonstrated ability to build good regulatory relationships also reduces regulatory risk for Terasen Gas.

**Trading Liquidity –** The liquidity of Terasen Gas' debt issues is moderate, with the debt trading on an occasional basis. The utility's capital market issues are essentially located at the short or long end of the curve and new issuers are well supported.

**New Issuance –** As was the case in 2007, we expect to see Terasen Gas in the market in 2008. The utility has a maturing debt issue of $188 million in June, which we expect to be refinanced. Further, the potential exists for a material portion of the utility's short-term notes, which were used to fund capex (not gas inventories), to be refinanced with longer-dated capital market issues. In Q3/07, the issuer had $280 million of short-term notes outstanding.




Source: BMO Capital Markets

## Credit Profile

**Company Financials –** Reflecting the seasonal nature of its earnings Terasen Gas recorded a loss in Q3/07. The $12.1 million loss was down from a loss of $13.5 million in Q3/06. FFO for Q3/07 of $7.8 million was down from $9.1 million a year earlier. Earnings and cash flows are expected to rebound in Q4/07. Liquidity in Q3/07 was adequate with unused bank lines of $177 million and leverage was temporarily higher at 66%, up from 63.5% at year-end 2006.

**Company Fundamentals –**Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex –** In Q3/07, Terasen Gas advised that there was no change to planned capex of $126 million in 2007. BMO Capital Markets equity research forecasts capex of $155 million in 2008.

**Credit Ratings –** After a period of rating uncertainty, Terasen Gas now has Stable outlooks on its three ratings. The most recent rating action was by Standard & Poor's, which on June 19, 2007, upgraded its rating on the utility three notches. We note the agency departed from its previous approach and assigned the rating on the basis of the utility's stand-alone credit quality. DBRS last confirmed its rating on Terasen Gas on Feb. 26, 2007, following the announced sale of Terasen to Fortis, while Moody's last confirmed its rating on Terasen Gas on Nov. 14, 2006.

| DBRS | S&P | Moody's |
|---|---|---|
| A | A | A3 |
| Stable | Stable | Stable |

**Disclosures:** 2, 3, 7, 9, 10AC

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 6.20% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Gas Inc. | 10.75% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 2-Oct-37 | $250 | MTNs | 2-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF1 | $250 |

## Ownership Structure

100% - Terasen Inc.

### Corp. Lease Schedule (9/30/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2007/08 | | 15.6 | |
| 2008/09 | | 15.4 | |
| 2009/10 | | 15.0 | |
| 2010/11 | | 14.6 | |
| 2011/12 | | 14.4 | |
| 2012 and Thereafter | | 95.0 | |

### Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q3/07 | Amount Available Q2/07 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $176.9 | $282.9 | Aug-12 | Unsecured committed revolving credit facility |

* Utilized lines are used for short-term borrowings and letters of credit.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $330 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2006 ($mm) | Pension Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2005 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 227.3 | 213.7 | 68.2 | 64.3 |
| Plan Assets | 228.9 | 202.4 | - | - |
| Funded Status | 1.6 | (11.3) | (68.2) | (64.3) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 7.6 | 4.8 | (38.3) | (31.1) |
| Discount Rate | 5.00% | 6.00% | 5.00% | 6.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation* | 3.64% | 3.36% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | A | Stable | 19-Jun-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CreditWatch Positive | 26-Feb-07 | A2 | Under Review - Negative | 2-Aug-05 |
| | | | BBB | CreditWatch Negative | 30-May-06 | A2 | Stable | 12-Dec-02 |
| | | | BBB | Negative | 6-Dec-05 | A2 | Under Review - Negative | 19-Nov-02 |
| | | | BBB | CreditWatch Negative | 2-Aug-05 | A2 | Stable | 7-Nov-01 |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CreditWatch Negative | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 8-May-01 | | | |

**Analyst's Certification**

I, Laurie Conheady, 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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**Company Specific Disclosure**

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Disclosure 3: BMO NB has provided investment banking services with respect to this issuer within the past 12 months.

Disclosure 7: BMO Capital Markets Corp. or an affiliate has received compensation for investment banking services from this issuer within the past 12 months.

Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Investment Banking Services & Non-Securities Related Services.

**Distribution of Ratings**

| **Rating Category** | **BMO Rating** | **BMO Universe** | **BMO I.B. Clients *** | **First Call Universe **** |
|---|---|---|---|---|
| Buy | Outperform | 38% | 42% | 49% |
| Hold | Market Perform | 53% | 52% | 46% |
| Sell | Underperform | 9% | 6% | 5% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

**Dissemination of Research**

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

**Additional Matters**

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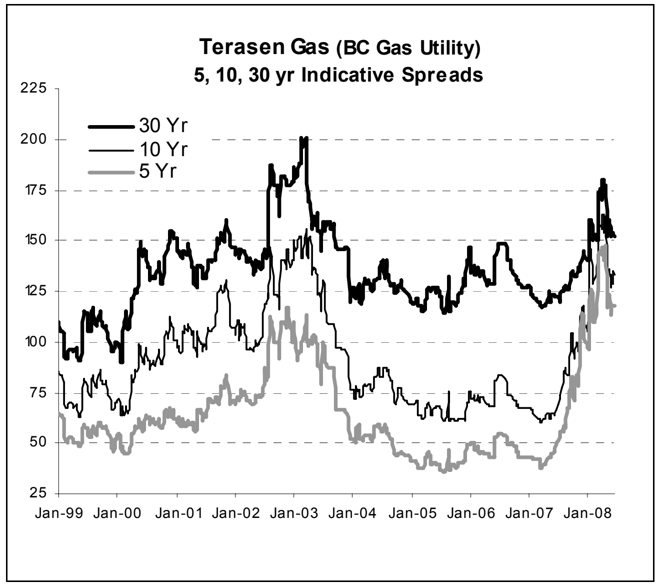
## Relative Value

**Recommendation –** Terasen Gas remains our preferred issuer among Canadian gas utility peers. Notwithstanding its low allowed ROE, the company's low business-risk profile, unique ring-fencing features, relatively high ratings and the access it has to the financial and management resources of the Fortis group of companies significantly reduce the risk for its bondholders. Supporting its spreads also is solid investor demand for its paper in the secondary and primary markets.

**Sector Value –** Relative to its gas utility peers, Terasen Gas' indicative spreads have tightened in recent months. After previously trading wide of its peers and presenting a relative value opportunity, Terasen Gas' spreads now trade more in line with our expectations, trading back of Gaz Metro Inc., in line with Enbridge Gas Distribution and inside those of Union Gas. We continue to believe the utility's ownership and ring-fencing features are positive distinguishing features relative to peers.

**Credit Curve –**Terasen Gas' spreads trade tight to similarly rated issuers. Nonetheless, compared to those of its peers, the utility's marginally steeper 5s-10s curve suggests better relative value in the mid-part of the curve.




Source: BMO Capital Markets

## Risks

**External –** We do not view political risk in British Columbia as a material credit concern for Terasen Gas. The government has not exhibited a tendency to intervene in regulatory determinations.

**LBO –** As a regulated operating subsidiary of Fortis Inc., Terasen Gas is not an LBO target. Further, although it cannot be completely ruled out, an LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A –** Having acquired the utility in 2007, we do not believe Fortis would look to divest Terasen Gas in the near term. Moreover, we expect Terasen Gas' focus will not be on M&A but on the integration with and leveraging off its owner.

**Regulatory –** The performance-based regulatory regime under which Terasen Gas operates is a positive feature of its business risk profile. Although low allowed ROE is expected to continue, the relatively transparent regulatory regime of the British Columbia Utilities Commission is not expected to present a major risk to the utility's credit profile. In May 2007, a two-year extension of the 2004–2007 Multi-Year Performance-Based Rate Plan for Terasen Gas was approved. Fortis' demonstrated ability to build good regulatory relationships also reduces regulatory risk for Terasen Gas.

**Trading Liquidity –** The liquidity of Terasen Gas' debt issues is moderate, with the debt trading on an occasional basis. The utility's capital market issues are largely located at the short or long end of the curve and new issues are well supported.

**New Issuance –** Terasen Gas has already been in the market in 2008, undertaking a $250 million MTN issue in May. Proceeds from the issue were to be used to refinance debt maturities and for general corporate purposes. The potential exists for a portion of the utility's short-term debt used to fund capex to be refinanced with longer-dated capital market issues. In Q1/08, the issuer had $252 million of short-term notes outstanding.

## Credit Profile

**Company Financials –** Higher operating income and lower taxes contributed to an 8.1% increase in net income to $50.6 million in Q1/08 versus Q1/07. The higher earnings pushed FFO to $73 million, up 2.7% versus Q1/07. Despite high seasonal cash flows, they were insufficient to fund capex of $27.5 million and a $14 million increase in dividends to $54 million. The cash flow shortfall was met through proceeds from the sale of land. Liquidity in Q1/08 was adequate, with unused bank lines of $204 million at quarter-end, and leverage was largely in line with expectations at 65%.

**Company Fundamentals –** Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex –** Terasen Gas has estimated total 2008 capex, before customer contributions, of $154.4 million. The company expects to fund the capex with long-term debt issuance, short-term borrowings and internally generated funds.

**Credit Ratings –** DBRS confirmed its rating on Terasen Gas on April 14, 2008. The confirmation reflects the issuer's low-business-risk natural gas distribution operations, a favourable regulatory environment with strong ring-fencing provisions, a strong franchise area and stable financial profile. Standard & Poor's last affirmed the rating on June 19, 2007, when it departed from its previous approach and assigned the rating on the basis of the utility's stand-alone credit quality and upgraded the rating three notches. In its credit opinion of May 27, 2008, Moody's advised that further sustained weakening of Terasen Gas's financial metrics would likely lead to a downgrade of its rating.

| DBRS | S&P | Moody's |
|---|---|---|
| A<br>Stable | A<br>Stable | A3<br>Stable |

**Disclosures:** 2, 3, 7, 9, 10AC

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 10.75% | 08-Jun-09 | $60 | Debentures | 08-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF1 | $250 |
| Terasen Gas Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole + 40 bps | 88078ZAG9 | $250 |

## Ownership Structure

100% - Terasen Inc.

## Corp. Lease Schedule (12/31/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2008 | | 15.7 | |
| 2009 | | 15.2 | |
| 2010 | | 14.9 | |
| 2011 | | 14.6 | |
| 2012 | | 14.3 | |
| 2013 and Thereafter | | 93.3 | |

## Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q1/08 | Amount Available Q4/07 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $204.0 | $152.0 | Aug-12 | Unsecured committed revolving credit facility |

*Utilized lines at March 31, 2008 were used for short-term borrowings ($252 million) and letters of credit ($44 million).

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $350 | 28-Apr-08 | 28-May-10 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2007 ($mm) | Pension Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2007 ($mm) | Other Benefit Plans FY 2006 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 236.0 | 227.3 | 68.7 | 68.2 |
| Plan Assets | 237.4 | 228.9 | - | - |
| Funded Status | 1.4 | 1.6 | (68.7) | (68.2) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 11.6 | 7.6 | (45.7) | (38.3) |
| Discount Rate | 5.00% | 5.00% | 5.00% | 5.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.63% | 3.64% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | A | Stable | 19-Jun-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | UR-Neg | 02-Aug-05 |
| | | | BBB | CW-Neg | 30-May-06 | A2 | Stable | 12-Dec-02 |
| | | | BBB | Negative | 06-Dec-05 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 02-Aug-05 | A2 | Stable | 07-Nov-01 |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

### Analyst's Certification

I, Laurie Conheady, 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.

### General Disclosure

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Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Investment Banking Services & Non-Securities Related Services.

### Distribution of Ratings

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | Starmine Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 43% | 53% | 52% |
| Hold | Market Perform | 48% | 45% | 42% |
| Sell | Underperform | 9% | 2% | 6% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

### Ratings Key

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

**Dissemination of Research**

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Ltd., BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

**Conflict Statement**

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**Additional Matters**

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## Relative Value

**Recommendation** – Terasen Gas remains our preferred issuer among Canadian gas utility peers. Notwithstanding its low allowed ROE, the company's low business-risk profile, unique ring-fencing features, relatively high ratings and the access it has to the financial and management resources of the Fortis group of companies significantly reduce the risk for its bondholders. Solid investor demand for its paper in the primary and secondary markets also supports its spreads.

**Sector Value** – Relative to its gas utility peers, Terasen Gas' indicative spreads have tightened in recent quarters. After previously trading wide of its peers and presenting a relative value opportunity, Terasen Gas' spreads now trade more in line with our expectations, trading back of Gaz Metro Inc., and Enbridge Gas Distribution (but not materially so) and inside those of Union Gas. We continue to believe the utility's ownership and ring-fencing features are positive distinguishing features relative to peers.

**Credit Curve** – The slope of Terasen Gas' credit curve is not materially out of line with those of its gas utility peers. In view of its relatively flat 5s-10s and particularly its 10s-30s curve, we see the opportunity for better relative value in the short-end.

## Risks

**External** – We do not view political risk in British Columbia as a material credit concern for Terasen Gas. The government has not exhibited a tendency to intervene in regulatory matters.

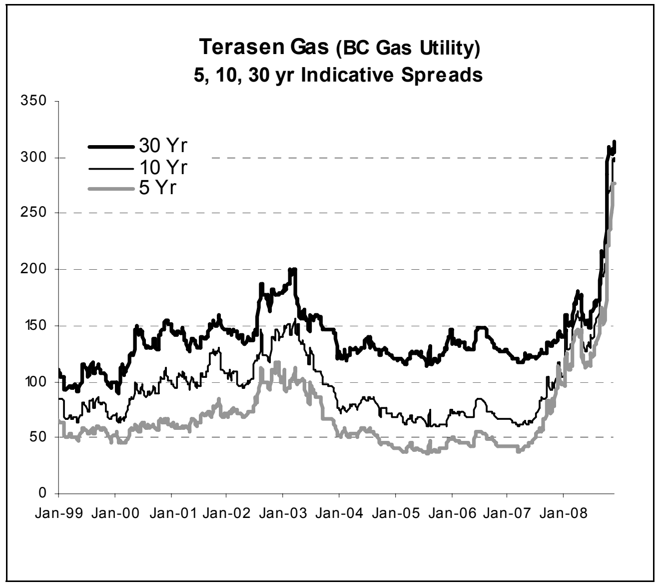
**LBO** – As a regulated operating subsidiary of Fortis Inc., Terasen Gas is not an LBO target. Further, although it cannot be completely ruled out, an LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A** – We do not believe Fortis would look to divest Terasen Gas in the near term. Moreover, we expect Terasen Gas' focus will not be on M&A but on leveraging off its owner and organically growing its business.

**Regulatory** – The performance-based regulatory regime under which Terasen Gas operates is a positive feature of its business risk profile. Although low allowed ROE is expected to continue, the relatively transparent regulatory regime of the British Columbia Utilities Commission is not expected to present a major risk to the utility's credit profile. In May 2007, a two-year extension of Multi-Year Performance-Based Rate Plan for Terasen Gas was approved. Fortis' demonstrated ability to build good regulatory relationships also reduces regulatory risk for Terasen Gas.

**Trading Liquidity** – The liquidity of Terasen Gas' debt issues is moderate, with the debt trading on an occasional basis. The utility's capital market issues are largely located at the short or long end of the curve and new issues are well supported.

**New Issuance** – Terasen Gas was in the market in 2008, undertaking a $250 million MTN issue in May. The utility has a small and manageable maturity in 2009, a $60 million debenture due mid-year. Further, potential exists for a portion of the utility's short-term debt used to fund capex to be refinanced with longer-dated capital market issues. In Q3/08, the issuer had $281 million of short-term notes outstanding.




Source: BMO Capital Markets

## Credit Profile

**Company Financials** – A higher income tax recovery reduced Terasen Gas' net loss to $6.3 million in Q3/08 compared to a loss of $12.1 million in Q3/07. Losses in the third quarter are typical given the seasonal nature of the business. The better result helped pushed FFO for the first nine months of 2008 to $105.5 million, up $10 million on 2007. The higher cash flows were insufficient to fund capex and dividends, with the cash flow shortfall met through working capital and debt issues. Liquidity at quarter-end was adequate with unused bank lines of $175.5 million, and leverage was largely in line with expectations, at 67%.

**Company Fundamentals** – Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex** – Terasen Gas advises that there are no material changes to its estimated total capex of $154.4 million in 2008, before customer contributions.

**Credit Ratings** – DBRS confirmed its rating on Terasen Gas on April 14, 2008. The confirmation reflects the issuer's low-business-risk natural gas distribution operations, a favourable regulatory environment with strong ring-fencing provisions, a strong franchise area and stable financial profile. Standard & Poor's last affirmed the rating on June 19, 2007, when it departed from its previous approach and assigned the rating on the basis of the utility's stand-alone credit quality and upgraded the rating three notches. In its credit opinion of May 27, 2008, Moody's advised that further sustained weakening of Terasen Gas's financial metrics would likely lead to a downgrade of its rating.

| DBRS | S&P | Moody's |
|---|---|---|
| A<br>Stable | A<br>Stable | A3<br>Stable |

**Disclosures:** 2, 3, 7, 9, 10AC

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 10.75% | 08-Jun-09 | $60 | Debentures | 08-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF1 | $250 |
| Terasen Gas Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole + 40 bps | 88078ZAG9 | $250 |

## Ownership Structure

100% - Terasen Inc.

### Corp. Lease Schedule (12/31/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2008 | | 15.7 | |
| 2009 | | 15.2 | |
| 2010 | | 14.9 | |
| 2011 | | 14.6 | |
| 2012 | | 14.3 | |
| 2013 and Thereafter | | 93.3 | |

### Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q3/08 | Amount Available Q2/08 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $175.5 | $289.5 | Aug-12 | Unsecured committed revolving credit facility |

*Utilized lines at September 30, 2008 were used for short-term borrowings ($281 million) and letters of credit ($43.5 million).

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $350 | 28-Apr-08 | 28-May-10 | MTNs |

## Pension Summary

| | Pension Benefit Plans FY 2007 ($mm) | Pension Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2007 ($mm) | Other Benefit Plans FY 2006 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 236.0 | 227.3 | 68.7 | 68.2 |
| Plan Assets | 237.4 | 228.9 | - | - |
| Funded Status | 1.4 | 1.6 | (68.7) | (68.2) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 11.6 | 7.6 | (45.7) | (38.3) |
| Discount Rate | 5.00% | 5.00% | 5.00% | 5.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.63% | 3.64% | NA | NA |

*Based on accrued benefit obligation assumptions.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | A | Stable | 19-Jun-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | UR-Neg | 02-Aug-05 |
| | | | BBB | CW-Neg | 30-May-06 | A2 | Stable | 12-Dec-02 |
| | | | BBB | Negative | 06-Dec-05 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 02-Aug-05 | A2 | Stable | 07-Nov-01 |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

**Analyst's Certification**

I, Laurie Conheady, 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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**Company Specific Disclosure**

Disclosure 2: BMO NB has undertaken an underwriting liability with respect to this issuer within the past 12 months.

Disclosure 3: BMO NB has provided investment banking services with respect to this issuer within the past 12 months.

Disclosure 7: BMO Capital Markets Corp. or an affiliate has received compensation for investment banking services from this issuer within the past 12 months.

Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp., BMO CM Ltd. or an affiliate within the past 12 months: Investment Banking Services & Non-Securities Related Services.

**Distribution of Ratings**

| **Rating Category** | **BMO Rating** | **BMO Universe** | **BMO I.B. Clients *** | **Starmine Universe **** |
|---|---|---|---|---|
| Buy | Outperform | 37% | 40% | 50% |
| Hold | Market Perform | 54% | 55% | 43% |
| Sell | Underperform | 9% | 5% | 7% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

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Und = Underperform - Forecast to underperform the market;

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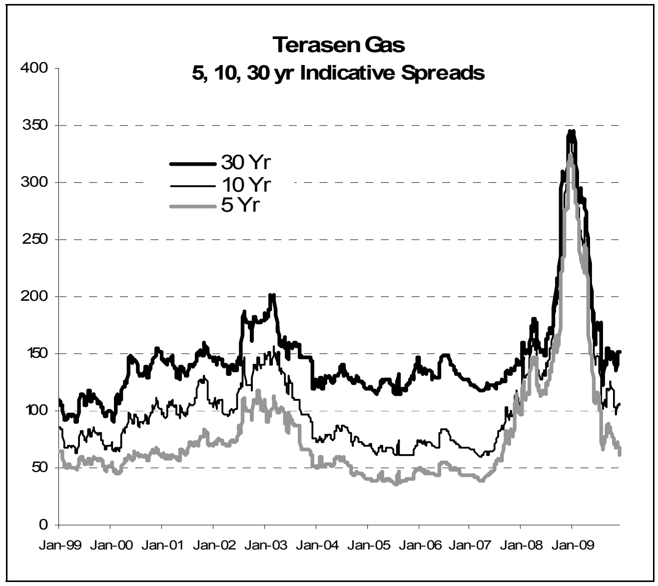
## Relative Value

**Recommendation –** While we expect a fairly stable operating and regulatory environment for Terasen Gas Inc., we see limited near-term catalysts for the company's spreads. A decision from the British Columbia Utilities Commission on Terasen Gas' return on equity and capital structure before the end of the year or early in 2010 may provide some opportunity for spread tightening, but we believe any positive momentum may be limited.

**Sector Value** – Over the medium term, Terasen Gas Inc's spreads will likely move in line with the spreads of other Canadian gas utility companies.

**Credit Curve** – Terasen Gas Inc's 10s-30s curve is at roughly 47 basis points while its 5s-10s curve is around 43 basis points, suggesting there is some relative value in the middle part of its curve.



Source: BMO Capital Markets

## Risks

**External –** An extended decline in economic conditions would be expected to reduce demand for energy over time. Energy sales are influenced by economic factors such as changes in employment levels, personal disposable income, energy prices and housing starts.

**M&A –** We do not believe Terasen Gas Inc. will be involved in any M&A activity over the forecast period.

**Regulatory** – Terasen Gas Inc. is subject to the regulatory determinations of the British Columbia Utilities Commission (BCUC), with respect to rates, capital expenditures and the authorized return on equity.

**Trading Liquidity** – We believe Terasen Gas Inc. exhibits below-average trading liquidity in the Canadian bond market.

**New Issuance** – Our estimates assume debt issuances of $100 million in 2010 and 2011.

**Other** – Failure on the part of various third parties to deliver natural gas supplies could have an adverse effect on Terasen Gas and its ability to distribute natural gas to the end consumer. The company is dependant on a single source transmission pipeline.

## Credit Profile

**Company Financials –** Terasen Gas Inc. had a free cash flow deficit of $28.6 million in Q3/09 versus a free cash flow deficit of $19.6 million in Q3/08. The decline in free cash flow is mainly attributable to an increase in capital expenditures ($35.2 million in Q3/09 vs. $32.6 million in Q3/08) and a change in seasonality. The free cash flow deficiency was mainly funded by draws on credit facilities. Gas volumes decreased 8,370 TJ in Q3/09, or 27.2 per cent, mainly due to lower average consumption as a result of warmer-than-normal weather. During the quarter, the company lost 795 customers, bringing the total number of utility customers to 833,277. Year-to-date 2009, the company has lost 934 customers compared to a net add of 3,260 customer in the same period last year. Weakness in housing and construction and the growth of multi-family housing (low natural gas penetration rate) have likely contributed to the decline.

**Company Fundamentals** – We expect a fairly stable operating and regulatory environment for Terasen Gas Inc. The company expects the number of residential customers to amount to 835,862 at year-end 2009, and increase by 5,952 customers in 2010 and by 6,166 customers in 2011.

**Capex –** Per Terasen Gas' 2010–2011 Negotiated Settlement Agreement dated November 26, 2009, capital expenditures are estimated to be $129.8 million in 2009, $153.1 million in 2010 and $178.9 million in 2011. Major capital expenditures in 2009 included the Gateway Infrastructure Project, the Fraser River South Bank South Arm Rehabilitation project, Customer Information System and an upgrade of SAP Core applications.

**Credit Ratings** – On July 10, 2009, S&P affirmed Terasen Gas Inc's A rating with a Stable Outlook. On May 28, 2009, Moody's affirmed Terasen Gas Inc's A3 rating with a Stable Outlook. On May 27, 2009, DBRS confirmed Terasen Gas Inc's A rating with a Stable Trend. Moody's rates Terasen Gas on a stand-alone basis, reflecting the ring-fencing provisions that are in place which insulate it from the greater financial and business risks of its parents, Terasen Inc. and Fortis Inc.

The ring-fencing conditions require that Terasen Gas: (i) maintain equity in the capital structure at least as high as the deemed equity level approved by the BCUC for ratemaking purposes (currently 35%); (ii) must obtain approval from the BCUC before paying dividend payments which could cause leverage levels to increase above the approved regulatory level; and (iii) refrain from extending loans or guarantees to affiliates or to investing in or providing support to non-regulated businesses.

| DBRS | S&P | Moody's |
|---|---|---|
| A | A | A3 |
| Stable | Stable | Stable |

**Disclosures:** 2, 3, 7, 9, 10AC

**Company Description** – Terasen Gas Inc. is the largest distributor of natural gas in British Columbia, serving approximately 833,277 residential, commercial and industrial customers in more than 100 communities. The major areas served include: Greater Vancouver, the Fraser Valley and the Thompson, Okanagan, Kootenay and North Central Interior regions. Terasen Gas Inc. is a wholly owned subsidiary of Terasen Inc. Terasen Gas (Vancouver Island) and Terasen Gas (Whistler) Inc. are also owned by Terasen Inc. Terasen Gas is regulated by the British Columbia Utilities Commission (BCUC).

*Website: www.terasengas.com*

**Corporate Developments** – On November 30, 2009, Terasen Gas announced that the BCUC has approved the company's 2010-2011 Revenue Requirements Negotiated Settlement Agreement. The negotiated settlement agreement approved the following key utility metrics: (i) rate base of $2,534.4 million in 2010 and $2,628.8 million in 2011; (ii) capital expenditures of $153.1 million in 2010 and $178.9 million in 2011; and (iii) deemed equity thickness of 35.01% in 2010 and 2011. It is our understanding that the performance-based rate-setting agreements expire on December 31, 2009, and have not been extended.

On May 15, 2009, Terasen Utilities (collectively Terasen Gas Inc., Terasen Gas (Vancouver Island) Inc. and Terasen Gas (Whistler) Inc.) filed a return on equity and capital structure application with the BCUC requesting an increase in allowed ROE to 11% from 8.47%, effective July 1, 2009, and an increase in its allowed common equity thickness to 40% from 35%, effective January 1, 2010. Terasen Utilities also requested the Commission eliminate the use of the ROE automatic adjustment mechanism. A decision on the application is expected before the end of the year or early in 2010.

**Recent Results** – Terasen Gas Inc. had a free cash flow deficit of $28.6 million in Q3/09 versus a free cash flow deficit of $19.6 million in Q3/08. The decline in free cash flow is mainly attributable to an increase in capital expenditures ($35.2 million in Q3/09 vs. $32.6 million in Q3/08) and a change in seasonality. The free cash flow deficiency was mainly funded by draws on credit facilities. Gas volumes decreased 8,370 TJ in Q3/09, or 27.2 per cent from the same period last year, mainly due to lower average consumption as a result of warmer-than-normal weather. During the quarter, the company lost 795 customers, bringing the total number of utility customers to 833,277. Year-to-date 2009, the company has lost 934 customers compared to a net add of 3,260 customer in the same period last year. Weakness in housing and construction and the growth of multi-family housing (low natural gas penetration rate) likely contributed to the decline. Debt to capitalization ratio decreased by approximately 30 bps to 64.9% as at Q3/09 compared to 65.2% as at year-end 2008.

**Capitalization and Liquidity** – Terasen Gas had $1.4 billion of long-term debt outstanding at September 30, 2009. Debt to capitalization ratio decreased by approximately 30 bps to 64.9% as at Q3/09 compared to 65.2% as at year-end 2008, and consistent with the company's targeted long-term capital structure consisting of 40% equity (including preferred shares) and 60% debt. The company has no debt maturities in 2010 and 2011. Terasen Gas has $250 million of medium term notes available under its $600 million shelf prospectus that expires on May 28, 2010. The company also had $304.3 million available on its $500 million unsecured committed revolving credit facility (maturing in August 2012) and cash of $5.1 million at September 30, 2009.

**Credit Ratings** – On July 10, 2009, S&P affirmed Terasen Gas Inc's A rating with a Stable Outlook. The ratings reflect the company's low-risk, regulated natural gas distribution business, its sound operational record and its free cash flow generation capability. The agency believes high leverage levels and the resulting below-average financial metrics constrain the ratings. S&P went on to note that an upgrade or positive outlook is unlikely, while a negative outlook or downgrade could result from operational difficulties or a decision to increase leverage.

On May 28, 2009, Moody's affirmed Terasen Gas Inc's A3 rating with a Stable Outlook. Moody's rates Terasen Gas on a stand-alone basis, reflecting the ring-fencing provisions that are in place, which insulate it from the greater financial and business risks of its parents, Terasen Inc. and Fortis Inc. The ratings reflect the utility's low-risk business model and supportive regulatory environment which partially offset its weak credit metrics. Moody's cited that the Terasen Gas has limited exposure to commodity prices, volume risks, pension funding costs, insurance costs and interest rate volatility on short-term debt through BCUC approved regulatory deferral mechanisms.

On May 27, 2009, DBRS confirmed Terasen Gas Inc's A rating with a Stable Trend. The ratings reflect the company's low business risk natural gas distribution operations, a favourable regulatory environment with strong ring-fencing provisions, a strong franchise area with a large customer base and a stable financial profile.

The ring-fencing conditions require that Terasen Gas: (i) maintain equity in the capital structure at least as high as the deemed equity level approved by the BCUC for ratemaking purposes (currently 35%); (ii) must obtain approval from the BCUC before paying dividend payments which could cause leverage levels to increase above the approved regulatory level; and (iii) refrain from extending loans or guarantees to affiliates or to investing in or providing support to non-regulated businesses.

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole (+ 35 bps) | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole (+ 28 bps) | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole (+ 31 bps) | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole (+ 29 bps) | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole (+ 34 bps) | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole (+ 37 bps) | 88078ZAF1 | $250 |
| Terasen Gas Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole (+ 40 bps) | 88078ZAG9 | $250 |
| Terasen Gas Inc. | 6.55% | 24-Feb-39 | $100 | MTNs | 24-Feb-09 | 285.0 bps | Make Whole (+ 71 bps) | 88078ZAH7 | $100 |

Source: Bloomberg

## Ownership Structure

100% - Terasen Inc.

### Corp. Lease Schedule (12/31/2008)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments |
|---|---|---|
| 2009 | | 15.4 |
| 2010 | | 15.0 |
| 2011 | | 14.7 |
| 2012 | | 14.4 |
| 2013 | | 13.5 |
| Thereafter | | 85.5 |

Source: Company Reports

### Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q3/09 | Amount Available Q2/09 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Gas Inc. | $500 | $304.3 | $397.3 | Aug-12 | Unsecured committed revolving credit facility |

Source: Company Reports

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $250 | 28-Apr-08 | 28-May-10 | MTNs |

Source: SEDAR

## Pension Summary

| | Pension Benefit Plans FY 2008 ($mm) | Pension Benefit Plans FY 2007 ($mm) | Other Benefit Plans FY 2008 ($mm) | Other Benefit Plans FY 2007 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 236.1 | 236.0 | 61.9 | 68.7 |
| Plan Assets | 207.9 | 237.4 | - | - |
| Funded Status | (28.2) | 1.4 | (61.9) | (68.7) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 16.4 | 11.6 | (52.2) | (45.7) |
| Discount Rate | 5.25% | 5.00% | 5.25% | 5.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.13% | 3.63% | NA | NA |

*Based on accrued benefit obligation assumptions.
Source: Company Reports.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | A | Stable | 19-Jun-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 30-May-06 | A2 | Stable | 07-Nov-01 |
| | | | BBB | Negative | 06-Dec-05 | | | |
| | | | BBB | CW-Neg | 02-Aug-05 | | | |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

Source: DBRS, S&P, Moody's

## Terasen Gas Inc.

| | 2005 | 2006 | 2007 | 2008 | LTM Q3/09 |
|---|---|---|---|---|---|
| EBITDA | 295.2 | 301.1 | 301.0 | 291.9 | 292.1 |
| EBIT | 216.0 | 217.2 | 222.5 | 213.6 | 210.4 |
| Net Income from Common Shares | 65.3 | 68.4 | 78.2 | 91.5 | 88.9 |
| Funds from Operations | 154.4 | 164.2 | 146.2 | 165.2 | 168.6 |
| Operating Cash Flow | 108.0 | 244.8 | 117.9 | 198.5 | 241.5 |
| Free Cash Flow | (58.3) | 15.5 | (73.1) | (56.9) | (8.6) |
| Capital Expenditures (excluding acquisitions) | 152.7 | 108.7 | 108.4 | 122.1 | 130.7 |
| Dividends | 60.0 | 40.0 | 110.9 | 100.0 | 46.5 |
| **Balance Sheet ($mm)** | | | | | |
| Short-term Debt | 313.0 | 217.0 | 305.0 | 238.5 | 150.0 |
| Long-term Debt (including current portion) | 1,351.6 | 1,350.0 | 1,340.6 | 1,401.7 | 1,442.4 |
| Shareholders' Equity | 845.7 | 901.4 | 878.2 | 875.0 | 859.6 |
| **Total Capitalization** | **2,510.3** | **2,468.4** | **2,523.8** | **2,515.2** | **2,452.0** |
| Short-term Debt | 12.5% | 8.8% | 12.1% | 9.5% | 6.1% |
| Long-term Debt (including current portion) | 53.8% | 54.7% | 53.1% | 55.7% | 58.8% |
| Shareholders' Equity | 33.7% | 36.5% | 34.8% | 34.8% | 35.1% |
| **Total Capitalization** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| **Key Ratios** | | | | | |
| Gross Profit Margin | 34.4% | 33.9% | 33.3% | 30.8% | 50.1% |
| Operating Margin | 20.1% | 19.7% | 19.7% | 17.5% | 18.9% |
| EBITDA Interest Coverage | 2.7x | 2.9x | 2.8x | 2.6x | 2.7x |
| EBIT Interest Coverage | 1.9x | 2.1x | 2.1x | 1.9x | 1.9x |
| Total Debt/EBITDA | 5.6x | 5.2x | 5.5x | 5.6x | 5.5x |
| Total Debt/Capital | 66.3% | 63.5% | 65.2% | 65.2% | 64.9% |
| Funds from Operations/Total Debt | 9.3% | 10.5% | 8.9% | 10.1% | 10.6% |
| **Key Statistics** | | | | | |
| Average Rate Base ($millions) | 2,406.0 | 2,516.0 | 2,484.4 | 2,510.2 | na |
| Growth Rate | | 4.6% | -1.3% | 1.0% | na |
| Deemed Equity | 33.0% | 35.0% | 35.0% | 35.0% | na |
| Allowed Return on Equity | 9.03% | 8.80% | 8.37% | 8.62% | na |

Source: Company Reports, BMO Capital Markets

**Analyst's Certification**

I, Benjamin Pham, 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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**Company Specific Disclosure**

Disclosure 2: BMO NB has undertaken an underwriting liability with respect to this issuer within the past 12 months.

Disclosure 3: BMO NB has provided investment banking services with respect to this issuer within the past 12 months.

Disclosure 7: BMO Capital Markets Corp. or an affiliate has received compensation for investment banking services from this issuer within the past 12 months.

Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp., BMO CM Ltd. or an affiliate within the past 12 months: Investment Banking Services & Non-Securities Related Services.

**Distribution of Ratings (Dec. 3, 2009)**

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | Starmine Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 40% | 50% | 50% |
| Hold | Market Perform | 51% | 46% | 43% |
| Sell | Underperform | 9% | 4% | 7% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;

Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

**Dissemination of Research**

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Ltd., BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

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http://research-ca.bmocapitalmarkets.com/conflict_statement_public.asp

**Additional Matters**

TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd.

TO U.K. RESIDENTS: In the UK this document is published by BMO Capital Markets Limited which is authorised and regulated by the Financial Services Authority. The contents hereof are intended solely for the use of, and may only be issued or passed on to, (I) persons who have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the “Order”) or (II) high net worth entities falling within Article 49(2)(a) to (d) of the Order (all such persons together referred to as “relevant persons”). The contents hereof are not intended for the use of and may not be issued or passed on to, retail clients.

BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltée/Ltd. are Members of CIPF. BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. are Members of SIPC.

## Relative Value

**Recommendation –** While we expect a fairly stable operating and regulatory environment for Terasen Gas Inc., we see limited near-term catalysts for the company's bonds. Also, we believe Terasen's spreads are reasonably valued among its gas utility peers, with spreads of Terasen Gas currently trading 4–5 basis points wider than those of the respective Enbridge Gas Distribution, compared to trading 15 basis points back at the beginning of the year.

**Sector Value** – Over the medium term, Terasen Gas Inc's spreads will likely move in line with the spreads of other Canadian gas utility companies.

**Credit Curve** – Terasen Gas Inc's 10s-30s curve is at roughly 30 basis points while its 5s-10s is around 34 basis points, suggesting there is some relative value in the middle part of its curve.

## Risks

**External** – An extended decline in economic conditions would be expected to reduce demand for energy over time. Energy sales are influenced by economic factors such as changes in employment levels, personal disposable income, energy prices and housing starts.

**M&A –** We do not believe Terasen Gas Inc. will be involved in any M&A activity over the forecast period.

**Regulatory** – Terasen Gas Inc. is subject to the regulatory determinations of the British Columbia Utilities Commission (BCUC), with respect to rates, capital expenditures and the authorized return on equity.

**Trading Liquidity** – We believe Terasen Gas Inc. exhibits below-average trading liquidity in the Canadian bond market.

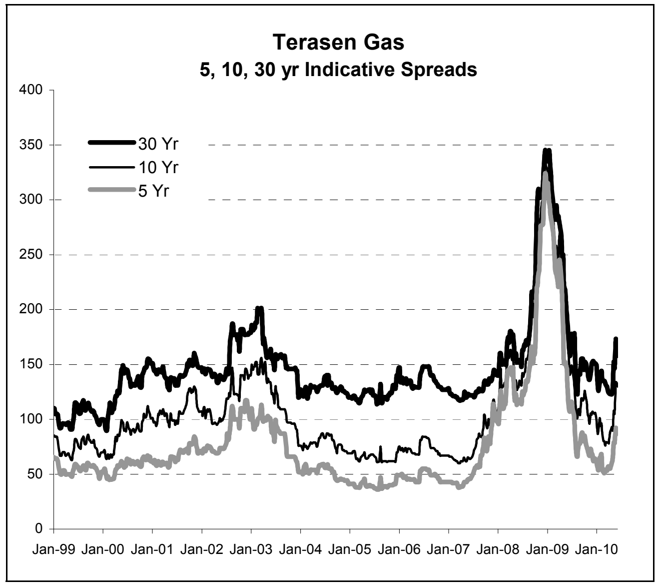
**New Issuance** – We do not expect Terasen Gas to be active in the primary markets this year.

**Other** – Failure on the part of various third parties to deliver natural gas supplies could have an adverse effect on Terasen Gas and its ability to distribute natural gas to the end consumer. The company is dependant on a single source transmission pipeline.

## Credit Profile

**Company Financials –** Terasen Gas Inc. had a free cash flow surplus of $37.0 million in Q1/10 versus a free cash flow surplus of $29.9 million in Q1/09. The improvement in free cash flow is mainly attributable to higher operating cash flow, which was partially offset by an increase in dividends paid ($20.0 million in Q1/10 vs. $11.5 million in Q1/09). During Q1/10, the company added 1,076 customers, bringing the total number of utility customers to 840,361. Although customer additions have increased, customer disconnections are higher y/y due to warmer weather. Also, the growth of multi-family housing (low natural gas penetration rate) continues to weigh on customer additions.

Terasen Gas had roughly $1.5 billion of long-term debt outstanding at March 31, 2010. Terasen Gas Inc's debt to capitalization ratio decreased by approximately 670 bps to 58.5% as at Q1/10 compared to 65.2% as at year-end 2009, due




Source: BMO Capital Markets

to the issuance of $125 million of common shares that was required as a result of the BCUC increasing the company's common equity component in its capital structure for rate-making purpose to 40% from 35%. The company has no debt maturities in 2010 and 2011. Terasen Gas has $600 million of medium term notes available under its shelf prospectus that expires on June 4, 2012. The company also had $414.3 million available on its $500.0 million unsecured committed revolving credit facility (maturing in August 2012) and cash of $3.9 million at March 31, 2010.

**Company Fundamentals** – We expect a fairly stable operating and regulatory environment for Terasen Gas Inc. The company expects the number of residential customers to increase by 5,952 customers in 2010 and by 6,166 customers in 2011.

**Capex** – BMO Capital Markets' is modeling capital expenditures of $327 million in 2010.

**Credit Ratings** – Terasen Gas Inc's debt is rated A, A and A3 by DBRS, Standard & Poor's, and Moody's, respectively. The outlook from all three rating agencies is stable. We note that Moody's rates Terasen Gas on a stand-alone basis, reflecting the ring-fencing provisions that are in place which insulate it from the greater financial and business risks of its parents, Terasen Inc., and Fortis Inc. The ring-fencing conditions require that Terasen Gas: (i) maintain equity in the capital structure at least as high as the deemed equity level approved by the BCUC for ratemaking purposes (currently 40%); (ii) must obtain approval from the BCUC before paying dividend payments which could cause leverage levels to increase above the approved regulatory level; and (iii) refrain from extending loans or guarantees to affiliates or to investing in or providing support to non-regulated businesses.

| DBRS | S&P | Moody's |
|---|---|---|
| A | A | A3 |
| Stable | Stable | Stable |

**Disclosures:** 5, 6C

# Terasen Gas Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
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Source: Bloomberg

## Ownership Structure

100% - Terasen Inc.

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| 2011 | | 14.8 |
| 2012 | | 14.5 |
| 2013 | | 13.5 |
| 2014 | | 13.0 |
| Thereafter | | 72.5 |

Source: Company Reports

### Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q1/10 | Amount Available Q4/09 | Maturity | Type |
|---|---|---|---|---|---|
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Source: Company Reports

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $600 | 14-May-10 | 14-Jun-12 | MTNs |

Source: SEDAR

## Pension Summary

| | Pension Benefit Plans FY 2009 ($mm) | Pension Benefit Plans FY 2008 ($mm) | Other Benefit Plans FY 2009 ($mm) | Other Benefit Plans FY 2008 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 264.4 | 236.1 | 57.8 | 61.9 |
| Plan Assets | 236.9 | 207.9 | - | - |
| Funded Status | (27.5) | (28.2) | (57.8) | (61.9) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 22.2 | 16.4 | (55.7) | (52.2) |
| Discount Rate | 6.25% | 5.25% | 6.25% | 5.25% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.13% | 3.13% | NA | NA |

*Based on accrued benefit obligation assumptions.
Source: Company Reports.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | A | Stable | 19-Jun-07 | A3 | Stable | 19-Dec-05 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 30-May-06 | A2 | Stable | 07-Nov-01 |
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| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

Source: DBRS, S&P, Moody's

## IMPORTANT DISCLOSURES

### Analyst's Certification

I, Benjamin Pham, 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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### Company Specific Disclosure

Disclosure 5: BMO Capital Markets or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

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### Distribution of Ratings (June 30, 2010)

| Rating Category | BMO Rating | BMOCM US Universe* | BMOCM US IB Clients** | BMOCM US IB Clients*** | BMOCM Universe**** | BMOCM IB Clients***** | Starmine Universe |
|---|---|---|---|---|---|---|---|
| Buy | Outperform | 37.1% | 13.7% | 43.6% | 40.9% | 51.0% | 54.4% |
| Hold | Market Perform | 59.3% | 10.4% | 52.7% | 54.8% | 45.4% | 40.2% |
| Sell | Underperform | 3.6% | 11.8% | 3.6% | 4.3% | 3.6% | 5.4% |

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

** Reflects rating distribution of all companies from which BMO Capital Markets Corp. has received compensation for Investment Banking services as percentage within ratings category.

*** Reflects rating distribution of all companies from which BMO Capital Markets Corp. has received compensation for Investment Banking services as percentage of Investment Banking clients.

**** Reflects rating distribution of all companies covered by BMO Capital Markets equity research analysts.

***** Reflects rating distribution of all companies from which BMO Capital Markets has received compensation for Investment Banking services as percentage of Investment Banking clients.

### Ratings and Sector Key

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. BMO Capital Markets eight Top 15 lists guide investors to our best ideas according to different objectives (Canadian large, small, growth, value, income, quantitative; and US large, US small) have replaced the Top Pick rating.

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### Prior BMO Capital Markets Ratings Systems

http://researchglobal.bmocapitalmarkets.com/documents/2009/prior_rating_systems.pdf

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A member of BMO Financial Group

# FortisBC Energy Inc.

BEN PHAM, CFA

## Relative Value

**Recommendation** – We recommend no more than a market-weight position in the debt securities of FortisBC Energy at this time. While we expect a fairly stable operating and regulatory environment for FortisBC Energy, we see limited near-term catalysts for the company's bonds. The bonds should continue to be supported by the decent competitiveness of natural gas in British Columbia and its strong ring-fencing provisions.

**Sector Value** – We believe FortisBC Energy's spreads are reasonably valued among its gas utility peers, with spreads of FortisBC Energy currently trading 2 bps wider than those of the respective Enbridge Gas Distribution, compared to trading 15 bps back at the beginning of 2010.

**Credit Curve** – FortisBC Energy Inc's 10s-30s curve is at roughly 30 bps, while its 5s-10s is around 30 bps, suggesting there is some relative value in the middle part of its curve.

## Risks

**External** – An extended decline in economic conditions would be expected to reduce demand for energy over time. Energy sales are influenced by economic factors such as changes in employment levels, personal disposable income, energy prices and housing starts.

**M&A** – We do not believe FortisBC Energy Inc. will be involved in any M&A activity over the forecast period.

**Regulatory** – FortisBC Energy Inc. is subject to the regulatory determinations of the British Columbia Utilities Commission (BCUC), with respect to rates, capital expenditures and the authorized return on equity.

**Trading Liquidity** – We believe FortisBC Energy Inc. exhibits below-average trading liquidity in the Canadian bond market.

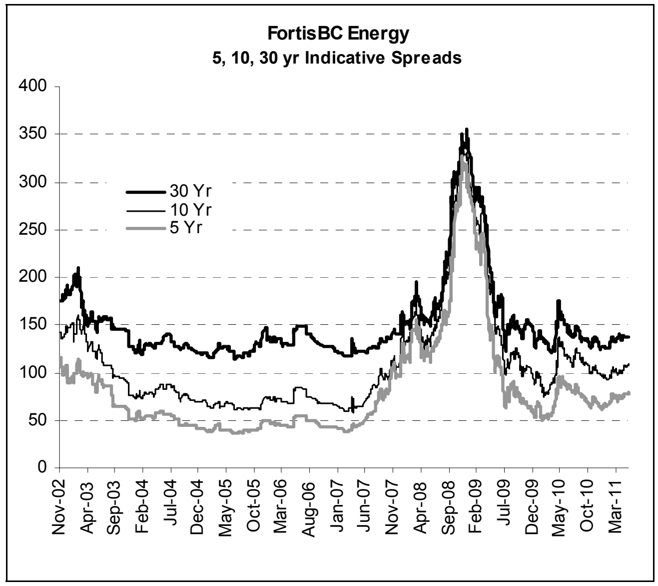
**New Issuance** – We are modelling up to $150 million of new issuance for FortisBC Energy in 2011.

**Other** – Failure on the part of various third parties to deliver natural gas supplies could have an adverse effect on FortisBC Energy and its ability to distribute natural gas to the end consumer. The company is dependant on a single source transmission pipeline.

## Credit Profile

**Company Financials** – FortisBC Energy Inc. had a free cash flow surplus of $23.7 million in Q1/11 versus a free cash flow surplus of $37.0 million in Q1/10. The variance in free cash flow is mainly attributable to higher dividends paid ($35.0 million in Q1/11 versus $20.0 million in Q1/10). During Q1/11, the company added 954 customers (versus a net customer increase of 1,076 in Q1/10), bringing the total number of utility customers to 847,188, in part driven by increased building activity.

FortisBC Energy had roughly $1.45 billion of long-term debt outstanding at March 31, 2011. FortisBC Energy Inc.'s debt to capitalization ratio decreased by 206 bps to 59.3% as at Q1/11 compared to 61.3% as at year-end 2010, due to higher shareholders' equity and repayment of short-term notes. The company has no debt maturities in 2011. FortisBC Energy has




Source: BMO Capital Markets

$600 million of medium term notes available under its shelf prospectus that expires on June 4, 2012. The company also had $366.3 million available on its $500.0 million unsecured committed revolving credit facility (maturing in August 2013) and cash of $10.1 million at March 31, 2011.

**Company Fundamentals** – We expect a fairly stable operating and regulatory environment for FortisBC Energy Inc. The company expects the number of residential customers to increase by 6,166 in 2011.

**Capex** – BMO Capital Markets' is modelling capital expenditures of $231 million in 2011 and $150 million in 2012.

**Credit Ratings** – FortisBC Energy Inc's debt is rated A and A3 by DBRS and Moody's, respectively. The outlook from the rating agencies is Stable. We note that Moody's rates FortisBC Energy on a stand-alone basis, reflecting the ring-fencing provisions that are in place which insulate it from the greater financial and business risks of its parents, FortisBC Holdings Inc. and Fortis Inc. The ring-fencing conditions require that FortisBC Energy: (i) maintains equity in the capital structure at least as high as the deemed equity level approved by the BCUC for ratemaking purposes (currently 40%); (ii) must obtain approval from the BCUC before paying dividend payments which could cause leverage levels to increase above the approved regulatory level; and (iii) refrain from extending loans or guarantees to affiliates or investing in or providing support to non-regulated businesses.

| DBRS | S&P | Moody's |
|---|---|---|
| A | Not rated | A3 |
| Stable | | Stable |

# FortisBC Energy Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| FortisBC Energy Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| FortisBC Energy Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole (+ 35 bps) | 05534RAB0 | $200 |
| FortisBC Energy Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole (+ 28 bps) | 05534ZAF3 | $150 |
| FortisBC Energy Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole (+ 31 bps) | 88078ZAB0 | $150 |
| FortisBC Energy Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole (+ 29 bps) | 88078ZAC8 | $150 |
| FortisBC Energy Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole (+ 34 bps) | 88078ZAE4 | $120 |
| FortisBC Energy Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole (+ 37 bps) | 88078ZAF1 | $250 |
| FortisBC Energy Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole (+ 40 bps) | 88078ZAG9 | $250 |
| FortisBC Energy Inc. | 6.55% | 24-Feb-39 | $100 | MTNs | 24-Feb-09 | 285.0 bps | Make Whole (+ 71 bps) | 88078ZAH7 | $100 |

Source: Bloomberg

## Ownership Structure

100% - FortisBC Holdings Inc.

Source: Company Reports

### Corp. Lease Schedule (12/31/2010)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments |
|---|---|---|
| 2011 | | 14.9 |
| 2012 | | 14.5 |
| 2013 | | 13.5 |
| 2014 | | 13.1 |
| 2015 | | 12.7 |
| Thereafter | | 61.0 |

Source: Company Reports

### Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q1/11 | Amount Available Q4/10 | Maturity | Type |
|---|---|---|---|---|---|
| FortisBC Energy Inc. | $500 | $366.3 | $277.3 | Aug-13 | Unsecured committed revolving credit facility |

Source: Company Reports

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| FortisBC Energy Inc. | Shelf | $600 | $600 | 14-May-10 | 14-Jun-12 | MTNs |

Source: SEDAR

## Pension Summary

| | Pension Benefit Plans FY 2010 ($mm) | Pension Benefit Plans FY 2009 ($mm) | Other Benefit Plans FY 2010 ($mm) | Other Benefit Plans FY 2009 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 314.9 | 264.4 | 69.1 | 57.8 |
| Plan Assets | 261.9 | 236.9 | - | - |
| Funded Status | (53.0) | (27.5) | (69.1) | (57.8) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 23.0 | 22.2 | (57.8) | (55.7) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.00% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.35% | 3.13% | NA | NA |

*Based on accrued benefit obligation assumptions.
Source: Company Reports.

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | NR | | 23-Oct-10 | A3 | Stable | 19-Dec-05 |
| | | | A | Stable | 19-Jun-07 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | Stable | 07-Nov-01 |
| | | | BBB | CW-Neg | 30-May-06 | | | |
| | | | BBB | Negative | 06-Dec-05 | | | |
| | | | BBB | CW-Neg | 02-Aug-05 | | | |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

Source: DBRS, S&P, Moody's

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**Distribution of Ratings (March 31, 2011)**

| Rating Category | BMO Rating | BMOCM US Universe* | BMOCM US IB Clients** | BMOCM US IB Clients*** | BMOCM Universe**** | BMOCM IB Clients***** | Starmine Universe |
|---|---|---|---|---|---|---|---|
| Buy | Outperform | 34.2% | 15.2% | 38.6% | 39.2% | 48.5% | 53.1% |
| Hold | Market Perform | 62.9% | 12.5% | 58.6% | 56.8% | 49.0% | 41.3% |
| Sell | Underperform | 2.9% | 13.3% | 2.9% | 4.1% | 2.5% | 5.5% |

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.
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Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
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# FortisBC Energy Inc.

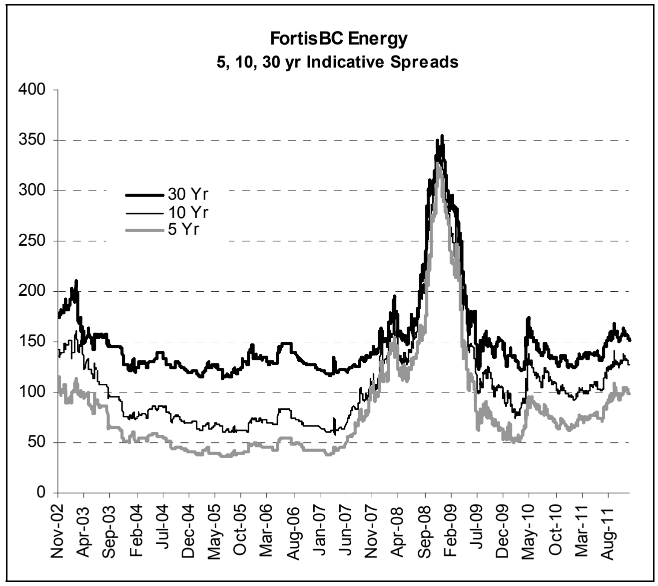
BEN PHAM, CFA

## Relative Value

**Recommendation** – We recommend no more than a market weight position in the debt securities of FortisBC Energy at this time. While we expect a fairly stable operating and regulatory environment for FortisBC Energy, we see limited near-term catalysts for the company's bonds. The bonds should continue to be supported by the decent competitiveness of natural gas in British Columbia and its strong ring-fencing provisions.

**Sector Value** – We believe FortisBC Energy's spreads are reasonably valued among its gas utility peers, trading at 98 bps in the 5-year (back of Enbridge Gas by 7 bps), 128 bps in the 10-year (back of Enbridge Gas by 10 bps) and 152 bps in the 30-year (back of Enbridge Gas by 2 bps).

**Credit Curve** – FortisBC Energy Inc's 10s–30s curve is at roughly 24 bps, while its 5s–10s is around 30 bps, suggesting there is some relative value in the middle part of its curve.




Source: BMO Capital Markets

## Risks

**External** – An extended decline in economic conditions would be expected to reduce demand for energy over time. Energy sales are influenced by economic factors such as changes in employment levels, personal disposable income, energy prices and housing starts.

**M&A** – We do not believe FortisBC Energy Inc. will be involved in any M&A activity over the forecast period.

**Regulatory** – FortisBC Energy Inc. is subject to the regulatory determinations of the British Columbia Utilities Commission (BCUC), with respect to rates, capital expenditures and the authorized return on equity.

**Trading Liquidity** – We believe FortisBC Energy Inc. exhibits below-average trading liquidity in the Canadian bond market.

**New Issuance** – During 2012, we believe the company has sufficient cash flows from operating activities to service interest on debt, pay dividends and finance capex.

**Other** – Failure on the part of various third parties to deliver natural gas supplies could have an adverse effect on FortisBC Energy and its ability to distribute natural gas to the end consumer. The company is dependent on a single source transmission pipeline.

## Credit Profile

**Company Financials** – FortisBC Energy Inc. had a free cash flow deficit of $31.8 million in Q3/11 versus a free cash flow deficit of $38.5 million in Q3/10. The variance in free cash flow is mainly attributable to higher cash flow from operations ($10.1 million in Q3/11 versus $2.3 million in Q3/10). Third-quarter results reflected higher transportation volumes due to improvements in the forestry and mining sectors coupled with mining customers burning more natural gas due to a shortage of coal. This was offset by lower demand from residential and commercial consumers due to warmer weather. During the third quarter of 2011, the company added 608 customers, bringing the total number of utility customers to 847,144.

FortisBC Energy had roughly $1.45 billion of long-term debt outstanding at September 30, 2011. FortisBC Energy Inc.'s debt to capitalization ratio decreased by roughly 100 bps to 60.4% as at Q3/11 compared to 61.3% as at year-end 2010, due to higher shareholders' equity and repayment of short-term notes. The company has no debt maturities in 2012. FortisBC Energy has $600 million of medium term notes available under its shelf prospectus that expires on June 14, 2012. The company also had $319.8 million available on its $500.0 million unsecured committed revolving credit facility (maturing in August 2013) and cash of $6.6 million at September 30, 2011.

**Company Fundamentals** – We expect a fairly stable operating and regulatory environment for FortisBC Energy Inc.

**Capex** – We are modelling capital expenditures of $147 million in 2012 and $127 million in 2013.

**Credit Ratings** – FortisBC Energy Inc's debt is rated A and A3 by DBRS and Moody's, respectively. The outlook from the rating agencies is Stable. We note that Moody's rates FortisBC Energy on a stand-alone basis, reflecting the ring-fencing provisions that are in place which insulate it from the greater financial and business risks of its parents, FortisBC Holdings Inc. and Fortis Inc. The ring-fencing conditions require that FortisBC Energy: (i) maintains equity in the capital structure at least as high as the deemed equity level approved by the BCUC for ratemaking purposes (currently 40%); (ii) must obtain approval from the BCUC before paying dividend payments which could cause leverage levels to increase above the approved regulatory level; and (iii) refrain from extending loans or guarantees to affiliates or investing in or providing support to non-regulated businesses.

| DBRS | S&P | Moody's |
|---|---|---|
| A | Not Rated | A3 |
| Stable | | Stable |

**Disclosures:** 1, 2, 4, 6A

# FortisBC Energy Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| FortisBC Energy Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| FortisBC Energy Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole (+ 35 bps) | 05534RAB0 | $200 |
| FortisBC Energy Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole (+ 28 bps) | 05534ZAF3 | $150 |
| FortisBC Energy Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole (+ 31 bps) | 88078ZAB0 | $150 |
| FortisBC Energy Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole (+ 29 bps) | 88078ZAC8 | $150 |
| FortisBC Energy Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make Whole (+ 34 bps) | 88078ZAE4 | $120 |
| FortisBC Energy Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole (+ 37 bps) | 88078ZAF1 | $250 |
| FortisBC Energy Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole (+ 40 bps) | 88078ZAG9 | $250 |
| FortisBC Energy Inc. | 6.55% | 24-Feb-39 | $100 | MTNs | 24-Feb-09 | 285.0 bps | Make Whole (+ 71 bps) | 88078ZAH7 | $100 |
| FortisBC Energy Inc. | 4.25% | 09-Dec-41 | $100 | MTNs | 09-Dec-11 | 163.0 bps | Make Whole (+ 41 bps) | 34959ZAA0 | $100 |

Source: Bloomberg

## Ownership Structure

100% - FortisBC Holdings Inc.

## Corp. Lease Schedule (12/31/2010)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments |
|---|---|---|
| 2011 | | 14.9 |
| 2012 | | 14.5 |
| 2013 | | 13.5 |
| 2014 | | 13.1 |
| 2015 | | 12.7 |
| Thereafter | | 61.0 |

Source: Company Reports

## Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q3/11 | Amount Available Q2/11 | Maturity | Type |
|---|---|---|---|---|---|
| FortisBC Energy Inc. | $500 | $319.8 | $411.8 | Aug-13 | Unsecured committed revolving credit facility |

Source: Company Reports

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| FortisBC Energy Inc. | Shelf | $600 | $500 | 14-May-10 | 14-Jun-12 | MTNs |

Source: SEDAR

## Pension Summary

| | Pension Benefit Plans FY 2010 ($mm) | Pension Benefit Plans FY 2009 ($mm) | Other Benefit Plans FY 2010 ($mm) | Other Benefit Plans FY 2009 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 314.9 | 264.4 | 69.1 | 57.8 |
| Plan Assets | 261.9 | 236.9 | - | - |
| Funded Status | (53.0) | (27.5) | (69.1) | (57.8) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 23.0 | 22.2 | (57.8) | (55.7) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.00% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation* | 3.35% | 3.13% | NA | NA |

**Based on accrued benefit obligation assumptions.

Source: Company Reports

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| A | Stable | 23-Aug-99 | NR | | 23-Oct-10 | A3 | Stable | 19-Dec-05 |
| | | | A | Stable | 19-Jun-07 | A2 | UR-Neg | 19-Nov-02 |
| | | | BBB | CW-Pos | 26-Feb-07 | A2 | Stable | 07-Nov-01 |
| | | | BBB | CW-Neg | 30-May-06 | | | |
| | | | BBB | Negative | 06-Dec-05 | | | |
| | | | BBB | CW-Neg | 02-Aug-05 | | | |
| | | | BBB | Stable | 26-Jun-03 | | | |
| | | | BBB+ | CW-Neg | 19-Nov-02 | | | |
| | | | BBB+ | Stable | 08-May-01 | | | |

Source: DBRS, S&P, Moody's

## IMPORTANT DISCLOSURES

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I, Benjamin Pham, 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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|---|---|---|---|---|---|---|---|
| Buy | Outperform | 39.2% | 12.6% | 38.8% | 42.5% | 48.1% | 57.2% |
| Hold | Market Perform | 58.9% | 13.2% | 61.2% | 54.6% | 50.9% | 38.5% |
| Sell | Underperform | 1.9% | 0.0% | 0.0% | 2.9% | 0.9% | 4.3% |

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# FortisBC Energy Inc.

**February 9, 2012**
Brief Research Note

**Ben Pham, CFA**
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Assoc: Ewa Bzorek, CA

## Q4 – A Solid Quarter; Limited Catalysts Keep Us On the Sidelines for Now

### Impact

Neutral.

### Details & Analysis

Fortis Inc. reported Q4/11 results this morning, providing a preview of quarterly financial results of its 100%-owned subsidiary FortisBC Energy (including the operations of Vancouver Island and Whistler). Highlights for FortisBC Energy: (1) reported earnings of $51 million in Q4/11 were higher than $45 million in Q4/10. The variance was due to rate base growth and lower corporate taxes, partially offset by lower-than-expected customer additions; (2) the company has forecast total capital expenditures for 2012 of approximately $244 million, compared to 2011 capex levels of $253 million. Notably, the $110 million Customer Care Enhancement project was placed in-service January 2012, with $30 million of the project costs to be incurred in the first half of 2012. The project entailed the insourcing of core elements of the company's customer care services including two company-owned call centres and billing operations, and implementation of a cost risk-sharing condition; (3) in September 2011, FortisBC Energy filed an updated revenue requirements application for 2012–2013, reflecting mid-year rate bases of $2,760 million in 2012 and $2,820 million in 2013; (4) in late 2011, the company temporarily suspended its application with the British Columbia Utilities Commission (BCUC) to amalgamate with FortisBC Energy (Vancouver Island) and FortisBC Energy (Whistler), while it provides additional information to the BCUC as requested. We are maintaining a Market Weight position in FortisBC Energy at this time. While we expect a fairly stable operating and regulatory environment for FortisBC Energy, we see limited near-term catalysts for the company's bonds. During 2012, we believe the company has sufficient cash flow from operating activities to service interest on debt, pay dividends and finance capex without incurring incremental debt.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| A | Not rated | A3 |
| Stable | | Stable |

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|---|---|---|---|---|---|---|---|
| Buy | Outperform | 38.0% | 10.3% | 40.4% | 40.7% | 46.2% | 56.2% |
| Hold | Market Perform | 60.3% | 9.6% | 59.6% | 56.3% | 52.2% | 39.4% |
| Sell | Underperform | 1.7% | 0.0% | 0.0% | 3.0% | 1.6% | 4.4% |

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# FortisBC Energy Inc.

May 2, 2012
Brief Research Note

**Mark Laing, CA, CFA**
(416) 359-4601
Mark.Laing@bmo.com
Assoc: Kathryn Nixon

## Q1 – A Solid Quarter

### Impact

Neutral.

### Details & Analysis

Fortis Inc. reported Q1/12 results this morning, providing a preview of quarterly financial results of its 100%-owned subsidiary FortisBC Energy. Highlights for FortisBC Energy: (1) reported earnings of $82 million in Q1/12 were $7 million higher than $75 million in Q1/11. The variance was due to rate base growth and higher transportation volumes, partially offset by lower-than-expected customer additions and lower capitalized AFUDC due to a lower asset base under construction during the quarter; (2) the company did not make any material changes to its forecasted total capital expenditures for 2012 of approximately $244 million, compared to 2011 capex levels of $253 million; (3) in April 2012, the British Columbia Utilities Commission (BCUC) issued its decision approving FortisBC Energy's updated revenue requirement application for 2012–2013, reflecting mid-year rate bases of $2.760 billion in 2012 and $2.820 billion in 2013; (4) in April 2012, the company refiled its application with the BCUC to amalgamate with FortisBC Energy (Vancouver Island) and FortisBC Energy (Whistler), after the application was suspended in late 2011 in order for additional information to be provided. We are maintaining a market weight position in FortisBC Energy at this time. While we expect a stable operating and regulatory environment for FortisBC Energy, we see limited near-term catalysts for the company's bonds. During 2012, we believe the company has sufficient cash flows from operating activities to service interest on debt, pay dividends and finance capex without incurring incremental debt.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| A<br>Stable | Not rated | A3<br>Stable |

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|---|---|---|---|---|---|---|---|
| Buy | Outperform | 37.7% | 12.1% | 52.1% | 39.2% | 48.3% | 54.6% |
| Hold | Market Perform | 60.0% | 7.0% | 47.9% | 57.6% | 51.0% | 40.1% |
| Sell | Underperform | 2.4% | 0.0% | 0.0% | 3.2% | 0.7% | 5.3% |

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# FortisBC Energy Inc.

July 31, 2012
Brief Research Note

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## Q2 Lower Than Expected

### Impact

Neutral.

### Details & Analysis

Fortis Inc. reported Q2/12 results this morning, providing a preview of quarterly financial results of its 100%-owned subsidiary FortisBC Energy. Highlights for FortisBC Energy: (1) reported earnings of $13 million in Q2/12 were $2 million lower than $15 million in Q2/11. The variance was due to lower-than-expected customer additions and lower capitalized AFUDC as a result of a lower asset base under construction in the quarter; (2) the company did not make any material changes to its forecast total capital expenditures for 2012 of approximately $244 million, compared to $253 million in 2011. The company indicated most of the remaining $30 million of project costs relating to the $110 million Customer Care Enhancement project, which was placed in service January 2012, were incurred in the first half of 2012; (3) in April 2012, the British Columbia Utilities Commission (BCUC) issued its decision approving FortisBC Energy's updated revenue requirement application for 2012–2013, reflecting mid-year rate bases of $2.76 billion in 2012 and $2.82 billion in 2013; (4) a regulatory review of the company's refiled application with the BCUC to amalgamate with FortisBC Energy (Vancouver Island) and FortisBC Energy (Whistler) is currently under way; and (5) in July 2012, the company extended its $500 million unsecured committed revolving credit facility agreement to August 2014 from August 2013. We are maintaining a market weight position in FortisBC Energy at this time. While we expect a stable operating and regulatory environment for FortisBC Energy, we see limited near-term catalysts for the company's bonds. During 2012, we believe the company has sufficient cash flows from operating activities to service interest on debt, pay dividends and finance capex without incurring incremental debt.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| A | Not rated | A3 |
| Stable | | Stable |

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| Rating Category | BMO Rating | BMOCM US Universe* | BMOCM US IB Clients** | BMOCM US IB Clients*** | BMOCM Universe**** | BMOCM IB Clients***** | Starmine Universe |
|---|---|---|---|---|---|---|---|
| Buy | Outperform | 39.2% | 14.2% | 66.0% | 39.7% | 49.1% | 55.7% |
| Hold | Market Perform | 58.8% | 4.6% | 31.9% | 57.1% | 48.6% | 39.3% |
| Sell | Underperform | 2.0% | 9.1% | 2.1% | 3.2% | 2.3% | 5.0% |

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.
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**Terasen Gas Inc. (senior unsecured A/ BBBpi/ A3)** spreads have widened since the management leveraged buyout offer for Kinder Morgan Inc. was announced on May 30th. Spreads on Terasen Inc. have widened far more than TGI spreads, a sign that investors recognize the degree of structural subordination of the Terasen Inc. bonds, and also probably recognize the value of the British Columbia Utilities Commission's ringfencing of TGI. Two rating agencies have affirmed TGI's ratings and stable outlooks, citing the ringfencing as "insulating TGI from the risks of its ultimate parent, KMI." (Moody's). One agency has remained silent on the credit relevance of the BCUC's ringfencing. We think that S&P's rating actions imply that it may view the ringfencing as not material to TGI's rating. In its press release on the KMI buyout proposal, we think S&P implies that TGI's senior unsecured debt rating would remain equal to KMI's corporate rating if the buyout succeeds and KMI's rating is downgraded to BB. We think it is important for market participants to carefully assess the value of the BCUC's ringfencing, and we offer our opinion as to its relevance and materiality to the creditworthiness of TGI.

BCUC

The British Columbia Utilities Commission is authorized, by the Province of British Columbia, pursuant to the BC Utilities Act, to have "general supervision of all public utilities, and may make orders about rates and other matters it considers necessary or advisable for the convenience of the public" (Sec 23). A utility "must obey the lawful orders of the commission made under this Act" (Sec 42). Additionally, the Act requires a public utility to "provide to the commission information required by the commission" (Sec 43). As shown in the example of KMI's acquisition of TGI, via its acquisitions of Terasen Inc., the BCUC has the powers under the Act to review proposed mergers or acquisitions of public utilities, and can impose conditions on the utility as it deems appropriate to protect the public interest. The BCUC's legislative authority to regulate is backed by the threat of penalties under the Act (Sec 106). Failure to obey an order of the commission can trigger fines of up to $10,000 per day, for as long as any such offence continues.

The authority of such regulatory bodies is well-recognized by judicial precedent in Canada. Recently, the Supreme Court of Canada's ruling in the City of Calgary v. ATCO Gas quoted liberally from past provincial court decisions. The Supreme Court ruled in favour of ATCO Gas against a certain ruling by the Alberta regulator regarding the allocation of the proceeds of sale of property no longer required to serve customers. While the Supreme Court sided with ATCO Gas in this matter, the majority decision made clear that, in matters within a regulatory board's technical expertise and mandate, and within the general purpose of legislation, "a high level of deference" by the courts to the board's judgement is appropriate. The minority added that "The Court should not substitute its own view (with that of the regulator) of what is 'necessary in the public interest'." With these judgements in mind, in our view, the courts would be highly unlikely to dismantle the BCUC's ringfencing of TGI.

Ringfencing

The following summary outlines the ringfencing measures put in place by the BCUC in its November 10, 2005 Decision as conditions of KMI's acquisition of TGI.

*1. Each (TGI) Utility shall maintain equity at least as much as that allowed for ratemaking.*
*2. No dividend can be paid if actual equity would dip below allowed equity.*
*3. a) No loans, guarantees, or financial support to affiliates (except between TGI and TG (Squamish) Inc. unless approved by BCUC; b) TGI and TGS maintain separate banking and cash management and TG Vancouver Island shall establish separate bank accounts and cash management; c) No tax sharing arrangements without BCUC approval.*
*4. Affiliate transactions on terms no less favourable than arms-length transactions.*
*5. No financial support or guarantee of non-regulated business unless approved by BCUC.*
*All the above may be revised and supplemented as required to protect the public interest.*
*Directors to remain independent.*

Let's consider a hypothetical situation where a distressed parent is highly motivated to wring liquidity from such a ringfenced subsidiary. The regulator is arguably not able to prevent a special dividend from being paid in contravention of item 2 above. However, penalties under Sec 106 of the Act could conceivably apply. Perhaps even more important, the regulator would in our view be likely to respond to such a decline in the utility's equity capitalization by reducing deemed equity. This could have the effect of reducing cash available for dividends in future periods, reducing the value of the regulated entity, and thereby penalizing the shareholder. The regulator could also penalize the shareholder if, in its view, the shareholder had unnecessarily raised the cost of debt financing of the utility, since the cost of debt financing is inevitably borne by ratepayers. In our view, a distressed parent would have every motivation (acting selfishly, and not out of concern for bondholders' welfare) to sell a utility as a healthy going concern, rather than impair its future value for short-term gain. It may be argued that an entity worth over $1 billion would take time to sell, and a sudden liquidity crunch could motivate a parent to "strip" a utility without regard for its future value. We don't find such an argument compelling, in the context of a sophisticated parent, operating in today's sophisticated financial markets.

Ratings

DBRS has rated TGI's debt at A continuously for many years. Moody's downgraded TGI senior unsecured debt to A3 at the same time that Terasen Inc. was downgraded, though Moody's made clear that, in light of the ring fencing, it evaluated TGI on a stand-alone basis. Both outlooks remain stable. S&P's BBB senior unsecured rating is on CreditWatch Negative, and the text of its May 31st press release strongly suggests that, if the buyout succeeds, KMI's senior unsecured debt ratings would be downgraded "well into the BB category." At present, KMI's and TGI's senior unsecured ratings are equal, and are both on CreditWatch, which seems to us to imply that a downgrade of KMI would trigger a downgrade of TGI. However, while there is no suggestion by S&P that TGI's ringfencing would become a rating factor if KMI were downgraded to non-investment grade, we must point out that S&P's press release does not explicitly rule out this possibility. In light of the BCUC regulation and ringfencing, we think a non-investment grade rating for TGI would be unwarranted. We do not think even a low BBB category rating describes TGI's risk of default.

S&P's rating on TGI became a "public information only" rating sometime in 2003 or early 2004. We think it ironic that, prior to this, S&P said in a research update on TGI that "The existing regulatory framework essentially determines the financial policies of Terasen Inc.'s regulated subsidiaries." We think this analytical conclusion still applies; but it seems S&P may not.

From March 2004, S&P's reports on TGI said "Ratings may be based solely on publicly available information, and may not involve the participation of the issuer's management." This language fell away after the KMI acquisition. While S&P enjoys the participation of KMI management in its rating on KMI, it is our understanding that S&P still does not have "the participation of the issuer's management" in respect of its rating on TGI.

Spreads

The threat of TGI moving to non-investment grade, even if only on an unsolicited, "public information only" basis, was a factor in TGI bonds widening at all maturities, with long bonds moving about 15 bps. While the potential for further widening on such a downgrade is hard to estimate, we think it would likely be moderate. Market participants have had time to react to S&P, based on their own assessment of the likelihood of the buyout succeeding. We note that it is possible S&P will decide that, in light of a lower rating for KMI, the TGI ringfencing would become material. Alternative scenarios we can imagine are S&P defusing the issue by dropping its "pi" rating on TGI, or, some time (possibly shortly) after a successful buyout, KMI could sell TGI, defusing the "KMI risk". While this would prolong ownership uncertainty, we believe there would be a significant number of extremely well-capitalized, interested bidders, which could lead to a stabilizing, or even a positive rating outcome. As well, we think that the BCUC's ringfencing would likely remain with any new ownership, at least until bond spreads appeared stabilized.

**Terasen Gas Inc. (senior unsecured A/ A/ A3)** has long been a favorite of ours within the gas distribution sector. Over most of the past several years, it has combined a substantial spread premium compared to sector peers, with what is in our view better credit quality compared to peers. None of TGI's peers debt instruments enjoy the extent of regulatory protection provided by the British Columbia Utilities Commission's regulatory ringfencing, which is unique and specific to TGI. Since late last year, the spread premium of TGI has all but vanished, as TGI secondary spreads have performed better than most peers in the "re-pricing" of credit over the last several months. Nonetheless, we still think highly of the credit enhancement offered by TGI's ringfencing protection. As well, TGI is now part of the Fortis group. Fortis' management of its regulated subsidiaries has a reputation for fostering safe, reliable operations, good customer satisfaction rates, and, as a result, typically good relations with regulators. After outperforming its sector peers over the past year, we now view Terasen Gas bonds as fairly valued at current spreads.

Financial results

Terasen Gas Q1 net earnings of $50.6 million were up 8% over last year, on a 0.9% increase in the number of customers, and a higher allowed ROE for 2008 (8.62%, from 8.37% in 2007). Gross margin on sales was up only 0.8%, though O&M declined 2.6% (on lower pension and OPEB), and depreciation declined slightly due to fully amortized software and hardware. Interest expense was up slightly, due to higher borrowing rates on short term debt. Q1 net income interest coverage was 2.85x, from 2.79x in 2007 and 2.75x in 2006. Cash flow interest coverage (before changes in non-cash working capital) was 3.66x, up a bit from 3.58x last year, but somewhat lower than the 3.8x to 4.5x coverage typical of Q1 over most of the past several years. The dividend paid to Terasen Inc. rose to $54 million, from $40 million. After the dividend, however, debt to capitalization was 64%, in line with the deemed regulatory 35% equity capitalization. We see TGI results as in-line with expectations.

The **Fortis Inc. (BBB(high)/ A-/ n.r.)** Q1 2008 report does not show comparative results from Q1 2007 for the Terasen Gas Companies, as the sale of Terasen from Kinder Morgan Inc. to Fortis was closed on May 15th last year. As well, Fortis' segment reporting discloses the results for the group of Terasen Gas Companies, which comprises all the Terasen B.C. local distribution companies: Terasen Gas Inc. (TGI) (which now includes Terasen Gas Squamish after a recent amalgamation); Terasen Gas Vancouver Island Inc. (TGVI); and Terasen Gas Whistler Inc. (TGWI). TGI is the issuer of Terasen Gas debt, so less than 100% of the Fortis reported segment "Terasen Gas Companies" earnings is available to support Terasen Gas debt.

We do know from history that Terasen Gas earnings are highly seasonal, and are typically modestly negative in Q2 as space heating requirements wane, and materially negative in Q3, as consumption for space heating falls to zero. Hence, we do not expect that the $50.6 million TGI net earnings, or the $58 million in operating earnings Fortis shows for the Terasen Gas Companies in Q1, is anything resembling a quarterly run-rate. Unfortunately, Terasen Gas does not disclose quarterly gas volumes by customer class. Nonetheless, we think that group total volumes, which Fortis said were up 3%, are likely representative of TGI volumes in the quarter. Some of the volume increase is attributed to customer growth, which is accretive to earnings. Some of the volume increase is due to colder than normal weather, which, over time, is earnings-neutral, as a result of regulatory deferral accounts. (We see this minimized exposure to weather as marginally favourable for credit quality.) Fortis did say that "The Terasen acquisition became accretive to earnings per share of Fortis in the first quarter", which is in line with management expectations, but perhaps a bit better than the expectations of some market observers. Fortis added that "The integration is progressing well." We view this good integration performance as very marginally positive for Terasen Gas spreads.

TGI has projected capex requirements of just over $150 million for 2008, in line with that of recent years. According to the TGI 2007 annual MD&A, capex may be financed from "a combination of long-term debt issuance, short-term borrowings and internally generated funds." Projects include life-cycle maintenance capex, transmission and distribution system upgrades, and computer systems applications. With good access to the commercial paper market, and $500 million in lines of credit ($204 million of which was undrawn as at March 31st), we think TGI has flexibility in timing its capital market financings.

Customer Growth

Total customer growth in 2007 was much less robust than in prior years this decade, falling to 0.5%, from nearly 1.5% in 2004 through 2006. Two distinct factors are at play. Residential customer growth is tied to new dwelling construction. National Energy Board studies, for example, cite the incentives of real estate developers to reduce their construction costs by installing only electricity services, rather than electricity and natural gas services, in new homes. We believe this trend to install only electricity services in new units, despite natural gas' operating cost advantage, is even more prevalent in the case of multi-unit dwellings. In the past few years, multi-unit dwelling construction has became more popular in the Lower Mainland. Industrial customer sales volumes were down about 11% in 2007, due to industrial customers switching to commercial and transport sales. TGI earns approximately the same margin on sales or transportation service. Transportation volumes were also down in 2007, by about 8%, due to lower volumes from one large customer, who was on a fixed price contract.

It is possible that over the past several years, residential consumer perceptions of rising and volatile natural gas costs, compared to the relatively stable retail price of electricity in B.C., may have influenced homebuyers' preferences for space heating and other appliances. However, after a decade of inertia, electricity prices in B.C. have begun to rise, with increases in 2004 (4.85%), 2006

(1.54%), and 2007 (2.10%). BC Hydro has recently applied to the BCUC for further rate increases of 6.56% and 8.21% for 2008 and 2009, respectively. Conservation measures have also made increased electricity consumption for industrial users much more expensive than in the past, and BC Hydro has requested a similar rising scale two-tier rate structure for residential users. It is not yet clear whether BC Hydro will proceed with its “Site C” hydro capacity expansion project. If it does, it may place further upward pressure on electricity rates. Even if BC Hydro does not proceed with Site C, rising imports could similarly place upward pressure on electricity rates.

We think that expected continued robust population growth, and the likelihood of continued rising B.C. electricity prices in future, should maintain a reasonable level of demand for natural gas service in some new home construction. Greatly increased exploration drilling for natural gas in Northeast B.C. may even help offset the impact of drilling declines in Alberta, ensuring abundant local supply, and keeping the B.C. commodity price in line with (or perhaps even a bit lower than) the price at major North American hubs.

Ultimately, a rising proportion of new electricity generation in B.C. may be sourced from natural gas-fired plants. If the cost of such new generation- including the cost of carbon offsets required to make new plants have net zero greenhouse gas emissions- is reflected in electricity prices (as we think it ought to be), then natural gas would become even more competitive for space heating. Environmental concerns and carbon emissions regulations may make the use of some relatively “dirty” alternate fuels (such as fuel oil, wood waste, coal, hog fuel, and tire-derived fuel) in industrial processes less attractive, also making natural gas comparatively more competitive, even if carbon emissions regulations increase the nominal cost of natural gas usage.

TGVI’s Mount Hayes LNG Facility

The proposed 1.5 Bcf LNG facility at Mount Hayes, near Ladysmith on Vancouver Island, is being undertaken by Terasen Gas Vancouver Island, a related company to TGI, wholly-owned by Terasen Inc. TGVI’s application to construct and operate the facility was granted a Certificate of Public Convenience and Necessity in December, and received final regulatory approval to proceed on April 1st. Natural gas from the facility will be available to serve Vancouver Island and Terasen Gas’ mainland customers, an arrangement that will optimize the use of existing transportation capacity and increase the winter peak delivery capability for both systems. Using compression, the facility will liquefy natural gas at a rate of 7.5 million cubic feet per day, filling it to capacity over 200 days. It can send out as much as 150 million cubic feet per day, 10% of storage capacity, more than enough to help the system meet even extreme peak demand periods in the winter. The facility will increase security of supply on Vancouver Island, as it can store roughly 25 days of winter demand, mitigating the impact of any temporary interruption of upstream physical supply. Increased storage capability, allowing more gas purchases in off-peak periods, may even reduce the volatility of the commodity price for Island gas consumers.

Under a contractual storage and delivery agreement between TGVI and TGI, 1.0 Bcf of the storage facility’s 1.5 Bcf of capacity will be allocated to TGI. Under most conditions, nominations by TGI for gas from the Mount Hayes facility will be met through deliveries on the Westcoast system to the existing Huntingdon/Sumas trading point near Abbotsford, displacing gas that otherwise would have continued to flow through the coastal transmission system to Vancouver Island. Modifications to the coastal transmission system will allow bi-directional flow. Hence, during peak send-out periods, gas from the LNG facility will be able to physically flow back to the Mainland along the coastal transmission system. Studies included in TGVI’s application for the Mount Hayes facility concluded that this arrangement was the most economic way to improve peak delivery capability on both systems, thus meeting system capacity expansion requirements in a cost-effective manner. The storage and delivery agreement has a fixed-price initial term of 20 years, and a cost-of-service based extension term of 15 years. This agreement between the two related companies has been approved in principle by the regulator. TGVI may reserve more storage capacity for its own use at the end of the initial 20 year term. Allocation of costs and rate design will be decided later, in a separate regulatory proceeding.

The facility has an estimated capital cost of $200 million. It remains to be seen how the facility will be financed, though as it is effectively regulated by the BCUC, with comparable operating risk characteristics as the transmission systems, we expect that domestic bond market financing by **TGVI (n.r./ n.r./ A3**) of roughly 60% of the total cost, to mirror the facility’s regulatory deemed capitalization, should be quite feasible. The facility is now scheduled for completion by April 1, 2011, to allow filling of the tank over the summer of 2011, and an in-service date of November 1, 2011, to be ready for drawdown in the winter of 2011-2012.

In its granting of the Certificate of Public Convenience and Necessity for the facility, the regulator turned down a TGVI request for a 50 bp premium for the facility over TGVI’s allowed ROE. In what we thought was rather sharp language, the BCUC appeared to assert that, under the relevant provincial legislation in B.C., it has the jurisdiction to direct TGVI (or any regulated utility) to make an investment in infrastructure, or provide a service, even if company management believes that the allowed returns are too low. While we see this as a reminder that Canadian utility regulation is not always friendly to investors, we continue to think that the bulk of such regulatory risks are effectively mainly borne by shareholders.

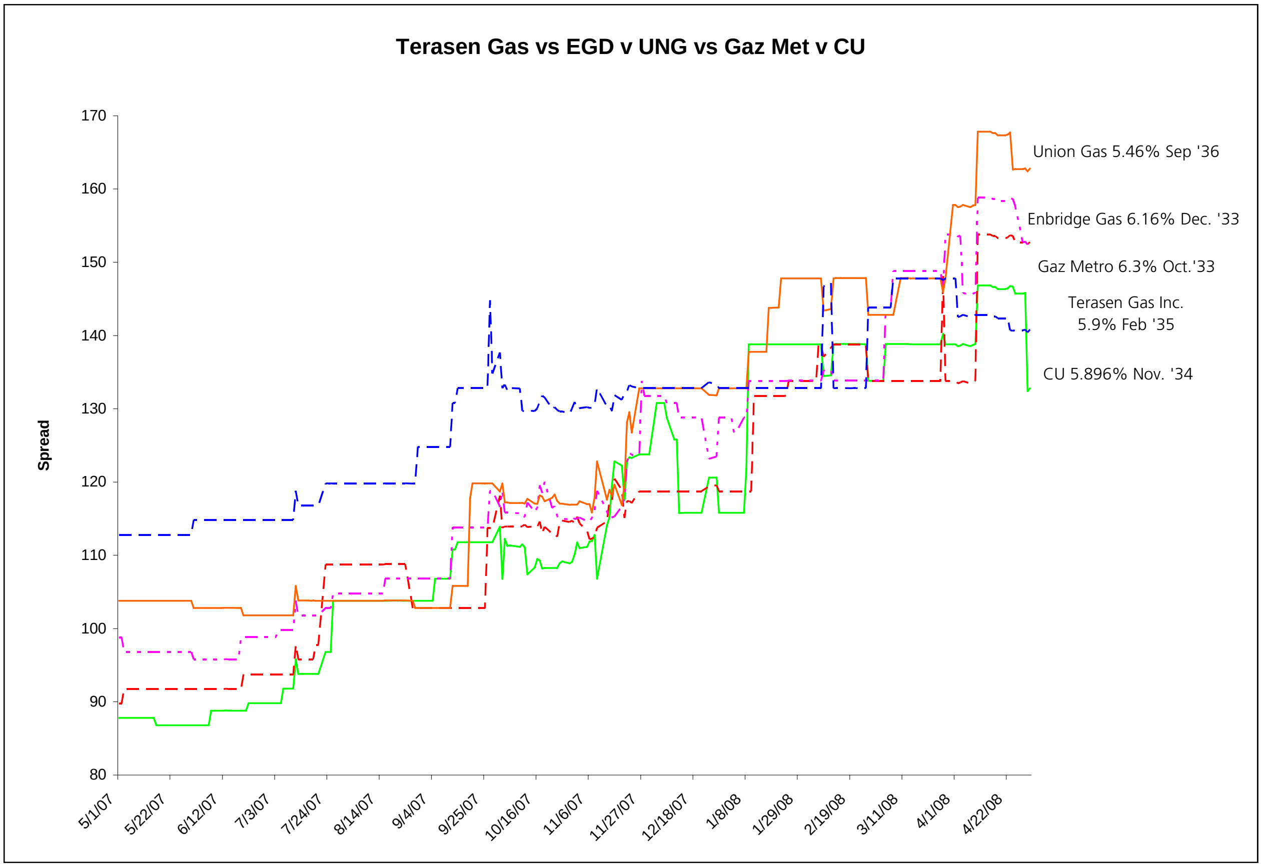
Terasen Inc.

Terasen Inc. reported net earnings of $52.4 million for its Q1, 2008. The net loss of $396 million reported in Q1 2007 was due to non-recurring items related to the disposition by Terasen Inc. of Trans Mountain and the other liquids pipelines, immediately prior to the sale of Terasen Inc., including only the gas distribution businesses, to Fortis. Cash from operations for Terasen Inc. was a healthy $81 million, allowing cash interest coverage of 3.0x, a $50 million dividend to Fortis, and a slight reduction in debt to capitalization to 66.5% from 67.0% at 2007 year-end. The loss of Enbridge Gas Distribution as a client of CustomerWorks LP (due to an Ontario

Energy Board ruling) appears to have been earnings-neutral for Terasen Inc.

We have not yet seen four "clean" quarters of Terasen Inc. results under Fortis ownership. Terasen Inc.'s Q1 and Q2, 2007 results were skewed by a number of non-recurring items related to the transaction, and also to KMI's corporate structure and financing of the Terasen companies. In particular, financing costs for Terasen Inc. in Q1 and Q2, 2007 were much higher under KMI than the run rate will be under Fortis, due to the capital structure and financing choices for Terasen Inc. made by KMI.

Fortis Inc.
As the ultimate parent of TGI, we view Fortis' financial strength as a point of interest, even though, under the restrictions of the BCUC's ringfencing, Fortis' strength is not in our view directly relevant to TGI's future financial position. Fortis set record net income for Q1, due to a full quarter's earnings contribution from Terasen Inc. All Fortis' rating outlooks are stable. We note that the S&P rating of TGI is linked to the Fortis rating. Hence, we view Fortis' fine Q1 results as tangentially positive for TGI bond spreads.



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# Terasen Inc.

**Janaury 5, 2006**
Research Comment

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## After the Dust Has Settled

### Event

All the rating agencies have completed their reviews of the acquisition of Terasen Inc. by Kinder Morgan Inc. (KMI).

### Impact

Negative.

### Key Points

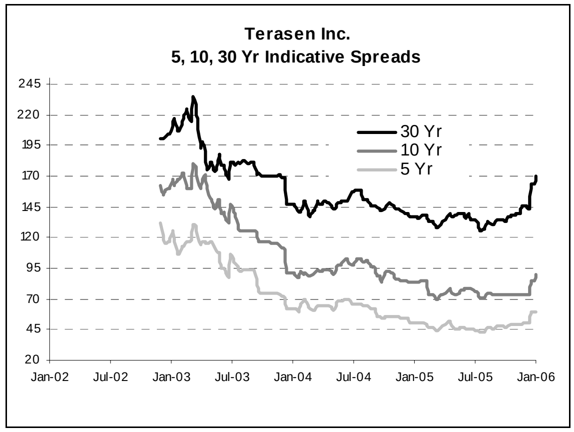
The reviews have resulted in consolidation of the ratings of Terasen Inc. at the BBB ratings level of KMI. DBRS and Moody's accepted the ring-fencing provisions of the British Columbia Utilities Commission, whereas S&P did not. DBRS left Terasen Gas' ratings unchanged at A. Moody's downgraded the company's senior unsecured credit ratings to A3 from A2 and the senior secured ratings to A2 from A1. S&P rates the senior unsecured debt of Terasen Gas at BBB. S&P has a Negative outlook on the credits of Terasen Inc., Terasen Gas and Kinder Morgan Inc. DBRS has a Negative outlook on the credits of Terasen Inc. and Kinder Morgan, but a Stable outlook on Terasen Gas. Moody's has a Stable outlook on all three credits.

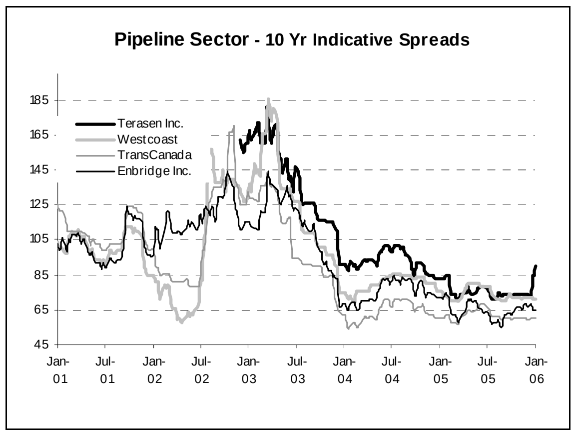
### Recommendation

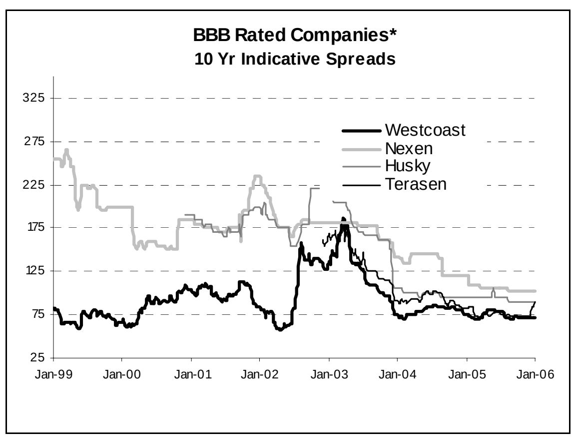
Terasen Inc. was among the worst performers in 2005, widening across the curve by 8, 7 and 33 basis points, respectively. In 2005, Terasen Gas.' credit spreads also widened by 8, 6 and 27 basis points, respectively. The majority of the spread widening occurred during the last month of the year and was likely triggered by the credit rating actions by S&P, DBRS and Moody's, as well as the issuance of US$2.1 billion by Kinder Morgan Finance Company ULC, a subsidiary of Kinder Morgan Inc. We believe that the credit spreads of Terasen Inc. will likely widen in the next 12 months, as we believe that a further downgrade by either S&P or Moody's or both is likely.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| BBB | BBB | Baa2 |
| Negative | Negative | Stable |




**Please refer to page 7 for Disclosure Statements, including the Analyst's Certification.**

## Summary of Credit Rating Actions

**Table 1. Summary of Terasen and Kinder Morgan Credit Ratings**

| | DBRS | | | | S&P | | | | Moody's | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Issuer | Previous Rating | Previous Outlook | New Rating | New Outlook | Previous Rating | Previous Outlook | New Rating | New Outlook | Previous Rating | Previous Outlook | New Rating | New Outlook |
| Terasen Inc. (Senior Unsecured) | A(L) | UR-Neg. | BBB(H) | Negative | BBB | CW-Neg. | BBB | Negative | A3 | UR-Neg. | Baa2 | Stable |
| Terasen Inc. (Unsecured Subordinated) | BBB(H) | UR-Neg. | BBB | Negative | BBB- | CW-Neg. | BBB- | Negative | Baa1 | UR-Neg. | Baa3 | Stable |
| Terasen Gas Inc. (Senior Unsecured) | A | Stable | A | Stable | BBB | CW-Neg. | BBB | Negative | A2 | UR-Neg. | A3 | Stable |
| Terasen Gas Inc. (Senior Secured) | Not Rated | | Not Rated | | A- | CW-Neg. | A- | Negative | A1 | UR-Neg. | A2 | Stable |
| Terasen Pipelines (Corridor) Inc. | A | Stable | A | Stable | Not Rated | | Not Rated | | A2 | Stable | A2 | Stable |
| Kinder Morgan Inc. | BBB | UR-Neg. | BBB | Negative | BBB | CW-Neg. | BBB | Negative | Baa2 | Stable | Baa2 | Stable |
| Kinder Morgan Energy Partners LP | BBB (H) | Stable | BBB (H) | Stable | BBB+ | CW-Neg. | BBB+ | Negative | Baa1 | Negative | Baa1 | Negative |

Source: DBRS, S&P and Moody's

## Terasen Inc.

On December 6, 2005, S&P reaffirmed its senior unsecured and unsecured subordinated debt ratings for Terasen Inc. at BBB and BBB-, respectively. The ratings were removed from Credit Watch with Negative implications, where they were placed on August 2, 2005, following the announcement by Kinder Morgan Inc. (KMI) of its planned acquisition of Terasen. The rating agency stated that the ratings of Terasen reflect the consolidated credit profile of its ultimate parent, KMI, in line with S&P's consolidated ratings methodology. The outlook for both KMI and Terasen Inc. is Negative. S&P believes that the majority debt-financed transaction weakens KMI's balance sheet and debt protection measures, and the rating agency does not expect the higher financial risk to be alleviated for several years as KMI pursues growth initiatives connected to the Terasen pipeline assets. S&P believes that KMI will be challenged to accomplish the integration of Terasen's assets and personnel while the greater financial exposure persists, and the Negative outlook on the ratings will remain until the integration process is completed or the balance sheet is strengthened.

On December 19, 2005, Moody's downgraded the senior unsecured credit ratings of Terasen Inc. to Baa2 from A3. The subordinated debt rating of Terasen Inc. was lowered to Baa3 from Baa1. The outlook was changed to Stable from Under Review for Possible Downgrade. Moody's has harmonized the ratings of Terasen Inc. with the senior unsecured rating of Kinder Morgan Inc. Moody's believes that the servicing and repayment of the US$2.15 billion debt raised by a subsidiary of KMI to finance the acquisition of Terasen will primarily be dependent on cash flow from Terasen Inc., thereby weakening the company's financial profile. Moody's stated that if KMI had not guaranteed the acquisition debt, then the rating agency would have lowered Terasen Inc.'s rating lower than Baa2. Moody's believes that while Terasen's historic core gas distribution subsidiaries provide the company with a stable, predictable stream of dividends, Terasen has significant exposure to the liquids transportation sector, which Moody's views as having a higher business risk profile relative to the regulated gas distribution sector. Moody's expects that this exposure will continue to increase, as one of KMI's key objectives in acquiring Terasen was to take advantage of growth opportunities in the liquids transportation business. Moody's sees execution risk associated with the possibility of undertaking the construction of multiple large and complex pipeline projects simultaneously.

On December 23, 2005, DBRS downgraded the credit ratings of Terasen Inc.'s unsecured subordinated debentures to BBB from A (Low). The outlook was changed to Negative from Under Review with Negative Implications. DBRS rates the company's senior unsecured bonds one notch higher at BBB (High). The rating change reflects the following: (1) the lower credit rating of the new owner, Kinder Morgan Inc. at BBB; (2) the substantial debt component used in the acquisition of Terasen Inc.; and (3) execution and financial risks associated with the company’s planned pipeline expansion program. To maintain its rating, DBRS expects KMI to maintain Terasen’s current status as the holding company for its wholly owned Canadian regulated subsidiaries. DBRS believes that if upstream dividends are maintained close to current levels, the estimated cash distributions from Terasen could cover most of the after-tax interest portion of the acquisition debt issued by Kinder Morgan Finance Company, ULC.

## Terasen Gas Inc.

On December 6, 2005, S&P reaffirmed its senior unsecured debt ratings for Terasen Gas Inc. at BBB. The rating agency said that the ratings of Terasen reflect the consolidated credit profile of its ultimate parent, KMI, in line with S&P's consolidated ratings methodology. S&P did not accept the ring-fencing provisions approved by the British Columbia Utilities Commission. The ratings were removed from Credit Watch with Negative Implications, where they were placed on August 2, 2005, following the announcement by Kinder Morgan Inc. of its planned acquisition of Terasen. The outlook for KMI, Terasen Inc. and Terasen Gas is Negative. The Negative outlook on Terasen reflects the outlook on its parent, KMI, which in turn reflects the considerable challenges faced by KMI as it works to integrate the Terasen assets and business operations into its corporate culture and systems at a time when its financial position is stretched. In particular, S&P believes that KMI has limited experience in Canada and in managing a large, closely regulated utility like Terasen Gas. The rating agency states that any operational problems or other indications that KMI's managerial capabilities are being stressed by the Terasen purchase could lead to a downgrade.

DBRS ratings on Terasen Gas Inc. were unchanged at A. The outlook is Stable. DBRS had not put the ratings of Terasen Gas Under Review with Negative Implications at the time of the merger (August 2005) as the rating agency had done with Terasen Inc. DBRS believes that due to the stand-alone nature of Terasen Gas’ operations, the business and financial risk profile of Terasen Gas is not changed by the KMI and Terasen transaction.

On December 19, 2005, Moody’s downgraded the senior unsecured credit ratings of Terasen Gas Inc. to A3 from A2. The senior secured ratings of Terasen Gas Inc. were lowered to A2 from A1. The outlook of both credits was changed to Stable from Under Review for Possible Downgrade. Moody’s has accepted the ring-fencing imposed by the British Columbia Utilities Commission and therefore evaluates Terasen Gas’ credit profile on a stand-alone basis. The downgrade of Terasen Gas reflects the company’s financial profile, which Moody’s considers weak relative to those of the company’s A2 rated global peers. Moody’s believes that the deemed equity and allowed ROE for Terasen Gas, the lowest in Canada, contribute to the company’s weak financial profile. Moody’s also considers the support provided by the company's regulatory environment, which limits the company’s exposure to commodity price and volume risks as well as pension funding costs, and insurance costs by operation of numerous deferral mechanisms. The Stable outlook reflects Terasen Gas’ low business risk as a regulated gas distribution utility and Moody's expectation that the recently imposed regulatory ring-fencing will effectively insulate the company from the higher financial and business risk of Terasen Inc.

### Kinder Morgan Inc.

On December 6, 2005, S&P affirmed the BBB rating on Kinder Morgan Inc. and changed the outlook to Negative from CreditWatch with Negative Implications. The ratings on KMI reflect the company's satisfactory business risk profile and a somewhat aggressive financial policy. S&P believes that KMI's credit measures should remain barely in line with its rating category and that growth-oriented capital spending will likely come at the expense of additional debt reduction in the medium term. The Negative outlook reflects the considerable challenges faced by KMI as it works to integrate the Terasen assets and business operations into its corporate culture and systems at a time when its financial position is stretched. In particular, S&P believes that KMI has limited experience in Canada and in managing a large, closely regulated utility like Terasen Gas. The rating agency states that any operational problems or other indications that KMI's managerial capabilities are being stressed by the Terasen purchase could lead to a downgrade.

On December 19, 2005, Moody's affirmed the ratings on KMI at BBB. The outlook remained unchanged at Stable.

On December 23, 2005, DBRS affirmed the rating on KMI at BBB and changed the outlook to Negative. The Negative outlook reflects KMI's high debt levels for its ratings category, which could be further pressured by substantial capital development programs at the Terasen Inc. level and the associated execution and financial risk. To maintain the ratings at the current level, DBRS expects KMI to increase efforts to reduce its balance sheet leverage and to improve its cash flow to debt ratio over the next two to three years. DBRS also expects KMI to manage its substantial capital investment programs prudently and without overburdening KMI's or Terasen's capital structure.

### Terasen Pipelines (Corridor)

We note that the respective A and A2 credit ratings of Terasen Pipelines (Corridor) were not affected by the acquisition of Terasen Inc. by Kinder Morgan. Both DBRS and Moody's have stated that the ratings in part reflect the strength of the firm service agreements and the quality of Corridor's two main shippers: Shell Canada (AA (Low) by DBRS, AA by S&P) and Chevron Canada, as guaranteed by its parent, ChevronTexaco (AA by DBRS, AA by S&P and Aa2).

## Recommendation

Terasen Inc. was among the worst performers in 2005, widening across the curve by 8, 7 and 33 basis points, respectively. In 2005, Terasen Gas.' credit spreads also widened by 8, 6 and 27 basis points, respectively. The majority of the spread widening occurred during the last month of the year and was likely triggered by the credit rating actions by S&P, DBRS and Moody's as well as the issuance of US$2.1 billion by Kinder Morgan Finance Company ULC, a subsidiary of Kinder Morgan Inc. The spreads that Kinder Morgan Finance Company ULC issued at in the U.S. were wider than the comparative credit spreads of Terasen Inc. when swapped back into Canada. At the time of the debt issue, Terasen Inc.'s 5-year, 10-year and 30-year generic credit spreads were trading at 50, 73 and 143 basis points, respectively, back of the respective Government of Canada bond benchmarks. Swapping back the 5-year, 10-year and 30-year Kinder Morgan Finance Company ULC's issues to Canada equated to approximately 73, 104 and 177 basis points back of the relevant GoC benchmark bonds.

We believe that the credit spreads of Terasen Inc. will likely widen in the next 12 months, as we believe that a further downgrade by either S&P or Moody's or both is likely. We caution that there is a possibility that Kinder Morgan redeems the outstanding debt that is callable ($325 million). The $100 million non-callable debt matures on May 8, 2006 and would likely not be refinanced under this scenario. We believe that the credit spreads of Terasen Gas will likely widen in the next 12 months. Although both Moody's and DBRS have accepted the British Columbia Utilities Commission's ring-fencing provisions, we believe that the credit is still exposed to the credit risk of its parent, Kinder Morgan.

We believe that Kinder Morgan faces the following risks and uncertainties with regards to the acquisition of Terasen:

1. Development Risk: as highlighted by the various rating agencies, KMI will likely be challenged to pursue the various pipeline development opportunities originally proposed by Terasen Inc. while keeping its financial metrics within the range of its current ratings.
2. The expiry of the Trans Mountain system's negotiated toll settlement at the end of 2005: the company is currently in negotiations with shippers to extend or renew the toll agreement. The company's earnings and cash flow in 2006 could be negatively affected by the outcome of the negotiation.
3. Regulatory risk at Terasen Gas: On July 11, the British Columbia Utilities Commission (BCUC) issued an Order and Notice of Procedural Conference regarding an application by Terasen Gas Inc. and Terasen Gas (Vancouver Island) Inc. to determine the appropriate return on equity and capital structure and to review and revise the automatic adjustment mechanism used by the BCUC to establish the allowed return on equity, annually. We believe that there is concern as to what the effect, if any, of the outcome of the British Columbia Utilities Commission's review. We are assuming a neutral decision, although the Commission could revise the mechanism to result in a ROE more comparative to the other utilities in Canada, which would be credit positive, or the Commission could adjust the mechanism downward, which would be credit negative.

# Terasen Inc.

### Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Inc. | 4.850% | 8-May-06 | $100 | MTNs | 8-May-03 | NA | Non-callable | 88079ZAA1 | $100 |
| Terasen Gas Inc. | 6.150% | 31-Jul-06 | $100 | MTNs | 30-Jul-01 | 73.0 bps | Make Whole + 18 bps | 88079ZAL0 | $100 |
| Terasen Gas Inc. | 9.750% | 17-Dec-06 | $20 | Retractable Debentures | 17-Dec-86 | NA | Non-callable | NA | $20 |
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | 6.200% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Inc. | 6.300% | 1-Dec-08 | $200 | MTNs | 30-Nov-01 | NA | Make Whole + 27 bps | 11058ZAA8 | $200 |
| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Pipelines (Corridor) | 4.240% | 2-Feb-10 | $150 | Senior Unsecured | 1-Feb-05 | 65.5 bps | Make Whole + 14 bps | 88079VAA0 | $150 |
| Terasen Pipelines Inc. | 11.500% | 1-Jun-10 | $35 | Senior Unsecured | 20-Jun-90 | NA | Make Whole + 50 bps | NA | $35 |
| Express Pipeline | 6.470% | 31-Dec-13 | US$150 | Senior Secured Notes | 6-Feb-98 | NA | Make Whole + 25 bps | 30217VAA5 | US$112.8 |
| Terasen Inc. | 5.560% | 15-Sep-14 | $125 | MTNs | 10-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Pipelines (Corridor) | 5.033% | 2-Feb-15 | $150 | Senior Unsecured | 1-Feb-05 | 81.1 bps | Make Whole + 19 bps | 88079VAB8 | $150 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Express Pipeline | 7.390% | 31-Dec-19 | US$250 | Subordinated Secured Notes | 6-Feb-98 | NA | Make Whole + 50 bps | 30217VAD9 | US$239.2 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Inc. | 8.000% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

[1]35 basis points to 3-month Bankers Acceptances

### Ownership Structure

Widely held.

### Credit Facilities

| Company | Facility Size | Amount Drawn FY 2004 | Amount Drawn FY 2003 | Letters of Credit Q3/04 | Letters of Credit FY 2003 | Maturity | Type |
|---|---|---|---|---|---|---|---|
| Terasen Inc. | $300 | $200.0 | $200.0 | | | NA | Lines of Credit |
| Terasen Gas Inc. | $500 | $188.0 | $353.0 | | | NA | Lines of Credit |
| Terasen Gas Vancouver | $215 | $160.0 | $160.0 | | | NA | Lines of Credit |
| Corridor Pipelines | $512 | $525.0 | $525.0 | | | NA | Lines of Credit |

### Shelf Prospectus

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $250 | 10-Dec-03 | 10-Jan-06 | MTNs |
| Terasen Inc. | Shelf | $800 | $800 | 10-Dec-03 | 10-Jan-06 | Unsecured Debentures |

### Pension Summary

| | Pension Benefit Plans | | Other Benefit Plans | |
|---|---|---|---|---|
| | FY 2004 ($mm) | FY 2003 ($mm) | FY 2004 ($mm) | FY 2003 ($mm) |
| Accrued Benefit Obligation | 298.0 | 276.7 | 67.3 | 61.0 |
| Plan Assets | 274.5 | 255.3 | - | - |
| Funded Status | (23.5) | (21.4) | (67.3) | (61.0) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 1.5 | 4.1 | (32.3) | (24.6) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation | 3.50% | 3.39% | NA | NA |

### Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| BBB | Negative | 23-Dec-05 | BBB | Negative | 6-Dec-05 | BBB | Stable | 19-Dec-05 |
| A (L) | UR-Negative | 2-Aug-05 | BBB | Credit Watch Negative | 2-Aug-05 | A3 | Under Review - Negative | 2-Aug-05 |
| A (L) | Stable | 4-Apr-00 | BBB | Stable | 26-Jun-03 | A3 | Stable | 12-Dec-02 |
| | | | BBB+ | Credit Watch Negative | 19-Nov-02 | A3 | Under Review - Negative | 19-Nov-02 |
| | | | BBB+ | Stable | 14-Nov-01 | A3 | Stable | 8-Nov-01 |

Note: On March 12, 2004, Terasen Inc. disengaged its relationship w ith S&P. The rating agency w ill continue to provide ratings on Terasen and its subsidiaries using public information.

**Analyst's Certification**

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# Terasen Inc.

**January 17, 2006**
Brief Research Note

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## Sale of Terasen Water and Utility Services

### Impact

Neutral.

### Details & Analysis

Kinder Morgan Inc. (KMI) has announced that Terasen Inc. (100% - KMI) has entered into a definitive agreement to sell Terasen Water and Utility Services (100% - Terasen Inc.) to a consortium including CAI Capital Management, a private venture company, and the existing management team of Terasen Water. The approximate $125 million purchase price will likely be used to pay down debt. Terasen Inc. has a $100 million 4.85% maturity on May 8, 2006. The Water and Utility Services business (including the company’s 30% ownership in CustomerWorks, which is not being sold) generated $6.6 million of earnings in 2004 with identifiable assets of $186.7 million at year-end 2004. Based on Karen Taylor's equity financial model, we had forecasted 2005 and 2006 earnings contribution from the Water and Utility Services segment of $11.3 million and $12.4 million, respectively. The sale is line with our expectations, as the water services business was not considered a core asset to KMI at the time of the acquisition. We believe that the credit spreads of Terasen Inc. and Terasen Gas will likely widen over the next 12 months, as we believe that there is a risk of further negative credit rating actions.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody’s |
|---|---|---|
| BBB | BBB | Baa2 |
| Negative | Negatie | Stable |

**Please refer to page 2 for Disclosure Statements, including the Analyst's Certification.**



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| Hold | Market Perform | 44% | 45% | 45% |
| Sell | Underperform | 13% | 11% | 9% |

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# Terasen Inc.

**January 26, 2006**
Brief Research Note

**Sue McNamara, CFA**
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## Kinder Morgan Canada Announces New Shipping Agreement

### Impact

Neutral.

### Details & Analysis

Kinder Morgan Canada (formerly Terasen Pipelines) has announced an agreement with shippers and producers encompassing the following elements: (1) a new five-year Incentive Tolling Settlement (ITS) for the Trans Mountain Pipeline; and (2) an expansion of the Trans Mountain Pipeline System (TMPL). There were no details released on the ITS regarding the tolling and expansion parameters, capacity allocation procedures for the Westbridge Marine terminal nor quality of service standards. The company stated that it expects to finalize the agreement by June 2006. The ITS is subject to approval by the National Energy Board (NEB). The $600 million two-staged expansion is designed to increase capacity on TMPL to 300,000 bbls/d by late 2008. In November 2005, the NEB approved the first stage of the expansion, involving a 35,000-bbls/d increase in capacity through the addition of pumping stations for a total cost of $235 million. The company expects to file a regulatory application for the second phase in February 2006. Both expansions are currently reflected in our equity financial model. We believe that Terasen Inc.'s credit spreads will likely widen in the next 12 months, as we believe that a further downgrade by either S&P or Moody's or both is likely. We estimate the proposed accounting consolidation of Kinder Morgan Energy Partners LP at the Kinder Morgan Inc. (KMI) level likely increases the company's proforma debt to total capital ratio to 63% versus 56% previously (at December 31, 2005). It is also expected to weaken other credit measures such as Debt to EBITDA and EBITDA coverage.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| BBB | BBB | Baa2 |
| Negative | Negative | Stable |

**Please refer to page 2 for Disclosure Statements, including the Analyst's Certification.**

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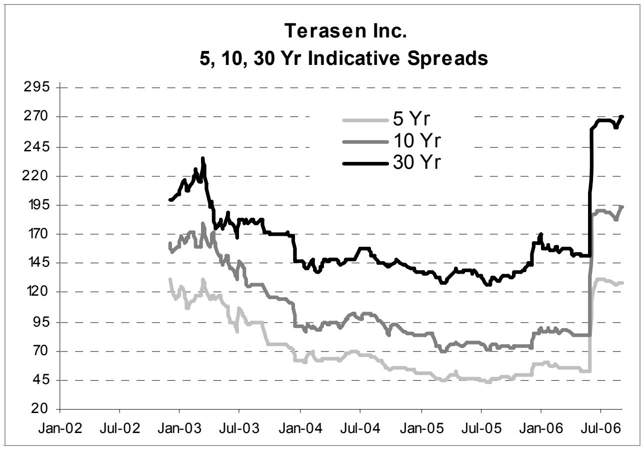


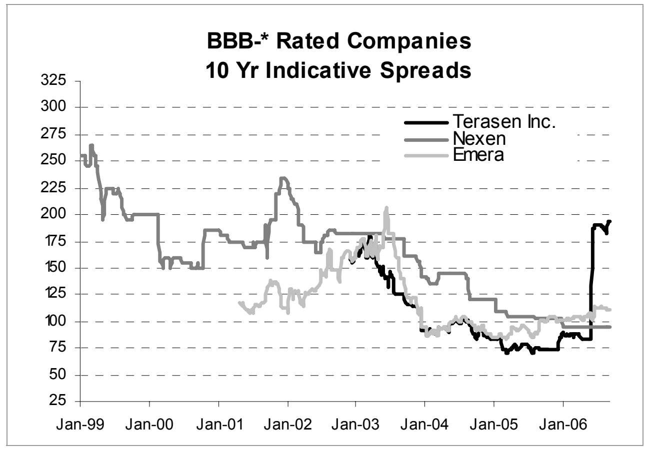


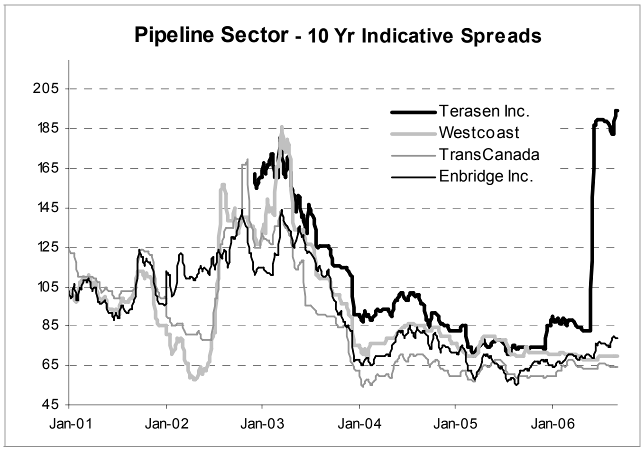


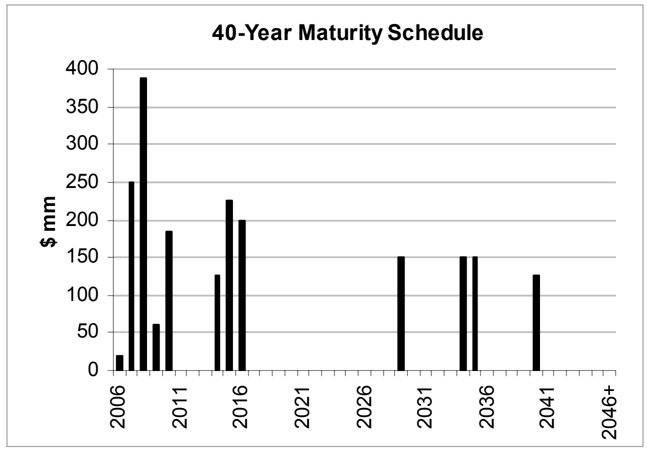


| DBRS | S&P | Moody's |
|---|---|---|
| BBB (High) | BBB- | Baa2 |
| UR - Negative | CW - Negative | UR - Negative |

**Index Weighting** – Terasen Inc. has a 0.02% weighting in the S&P/TSX Canadian Corporate Bond Index and a 0.61% weighting in the Utilities sector of the index.

**Company Description** – Terasen Inc. is a 100%-owned subsidiary of U.S. based Kinder-Morgan Inc. (KMI). KMI acquired Terasen Inc. on November 30, 2005. Terasen Inc.'s businesses include natural gas distribution, and crude oil and refined products transportation. *Website:www.terasen.com*

**Recent Results** – Reflecting the seasonal nature of its gas distribution business and higher taxes, Terasen recorded a $1.6 million loss in Q2/06. This compares to a profit of $29.5 million in Q2/05, which included $27.1 million of earnings from discontinued operations. Lower cash flows and higher capex led to free cash flow of -$37.3 million for Q2/06.

**Corporate Developments** – On August 28, 2006, KMI announced it had signed a definitive merger agreement, under which KMI would be acquired by way of a management buyout. The transaction, expected to be completed by early 2007, is subject to receipt of stockholder and regulatory approvals.

**Capitalization and Liquidity** – Terasen Inc. had consolidated debt of $2.76 billion at June 30, 2006, down $336 million from Dec. 31, 2005 largely due to reduced short-term debt. Total debt to capital was 65% versus 68.6% at Dec. 31, 2005. At the end of Q2/06, Terasen Inc. had $36.9 million of available cash and short-term investments, and $618 million of available capacity under its consolidated lines of credit of $1.175 billion.

**Credit Ratings** – Following the May 30, 2006, announcement of the move to take KMI private DBRS placed its ratings on Terasen Inc. Under Review with Negative Implications (confirmed on Sept. 11, 2006) and confirmed its A rating and Stable trend on Terasen Gas Inc; Standard & Poor's placed its ratings on KMI and its wholly owned subsidiaries, Terasen Inc. and Terasen Gas Inc., on CreditWatch with Negative Implications; and Moody's placed the ratings of Terasen Inc. Under Review for possible downgrade, but affirmed with Stable outlooks Terasen Gas Inc. and Terasen Pipelines (Corridor) Inc.

**Debt Recommendation** – Terasen Inc.'s 10- and 30-year generic credit spreads have widened 5–6 basis points further than where they were after the KMI buyout was announced. Year-to-date 2006, Terasen Inc.'s 5-, 10- and 30-year generic credit spreads are 70, 103 and 98 basis points wider, respectively. We view Terasen Inc. as a more suitable buy for high yield investors.

# Terasen Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 9.750% | 17-Dec-06 | $20 | Retractable Debentures | 17-Dec-86 | NA | Non-callable | NA | $20 |
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | Floating | 24-Oct-07 | $150 | Floating Rate Notes | 24-Oct-05 | NA | Non-callable | 88078ZAD6 | $150 |
| Terasen Gas Inc. | 6.200% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Inc. | 6.300% | 1-Dec-08 | $200 | MTNs | 30-Nov-01 | NA | Make Whole + 27 bps | 11058ZAA8 | $200 |
| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Pipelines (Corridor) | 4.240% | 2-Feb-10 | $150 | Senior Unsecured | 1-Feb-05 | 65.5 bps | Make Whole + 14 bps | 88079VAA0 | $150 |
| Terasen Inc. | 5.560% | 15-Sep-14 | $125 | MTNs | 10-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Pipelines (Corridor) | 5.033% | 2-Feb-15 | $150 | Senior Unsecured | 1-Feb-05 | 81.1 bps | Make Whole + 19 bps | 88079VAB8 | $150 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Inc. | 8.000% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

## Ownership Structure

100% - Kinder Morgan Inc.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $700 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Corp. Lease Schedule (12/31/2005)

| Year | Capital Lease Payments ($mm) | Operating Payments | Lease Receipts |
|---|---|---|---|
| 2006 | | 21.3 | |
| 2007 | | 20.2 | |
| 2008 | | 20.6 | |
| 2009 | | 19.3 | |
| 2010 | | 18.2 | |
| Thereafter | | 127.5 | |

## Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q2/06 | Amount Available FY 2005 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. & subsidiaries | $1,175 | $618 | $375 | NA | Lines of Credit |

## Pension Summary

| | Pension Benefit Plans FY 2005 ($mm) | Pension Benefit Plans FY 2004 ($mm) | Other Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2004 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 344.4 | 298.0 | 81.9 | 67.3 |
| Plan Assets | 298.5 | 274.5 | - | - |
| Funded Status | (45.9) | (23.5) | (81.9) | (67.3) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 0.4 | 1.5 | (40.1) | (32.3) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.50% | 3.50% | NA | NA |

## Historical Ratings

**DBRS**

| Rating | Trend | Date |
|---|---|---|
| BBB (H) | UR-Negative | 30-May-06 |
| BBB (H) | Negative | 23-Dec-05 |
| A (L) | UR-Negative | 2-Aug-05 |
| A (L) | Stable | 4-Apr-00 |

**S&P**

| Rating | Trend | Date |
|---|---|---|
| BBB- | CreditWatch Negative | 30-May-06 |
| BBB- | Negative | 6-Dec-05 |
| BBB- | CreditWatch Negative | 2-Aug-05 |
| BBB- | Stable | 26-Jun-03 |
| BBB | CreditWatch Negative | 19-Nov-02 |
| BBB | Stable | 14-Nov-01 |

**Moody's**

| Rating | Trend | Date |
|---|---|---|
| Baa2 | Under Review - Negative | 30-May-06 |
| Baa2 | Stable | 19-Dec-05 |
| A3 | Under Review - Negative | 2-Aug-05 |
| A3 | Stable | 12-Dec-02 |
| A3 | Under Review - Negative | 19-Nov-02 |
| A3 | Stable | 8-Nov-01 |

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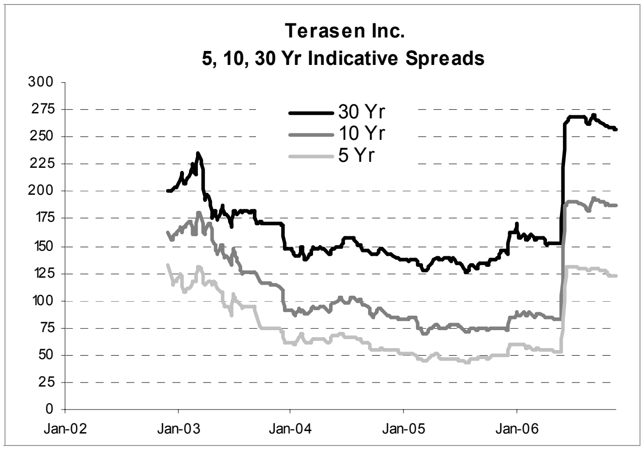
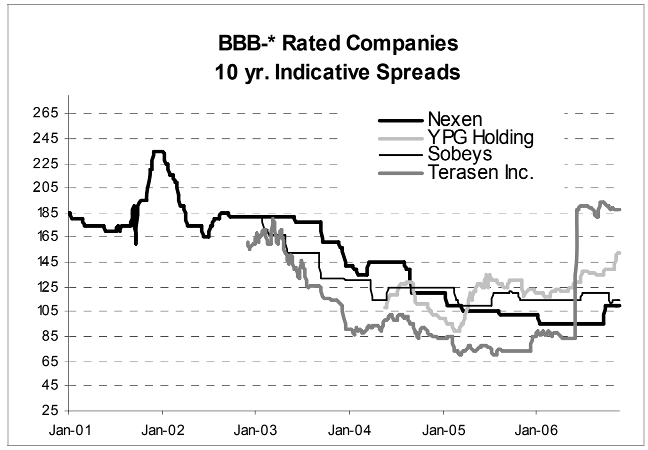
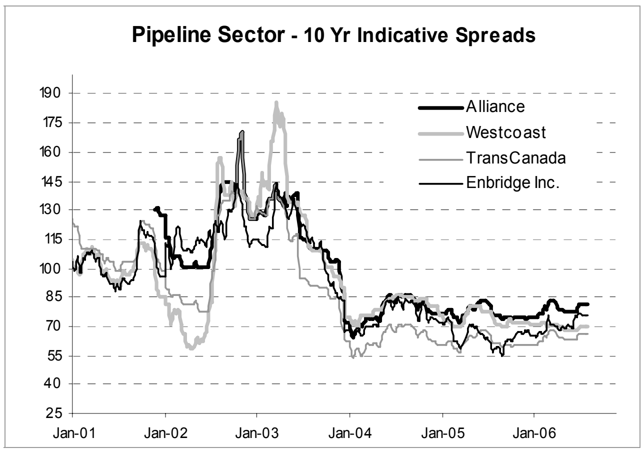
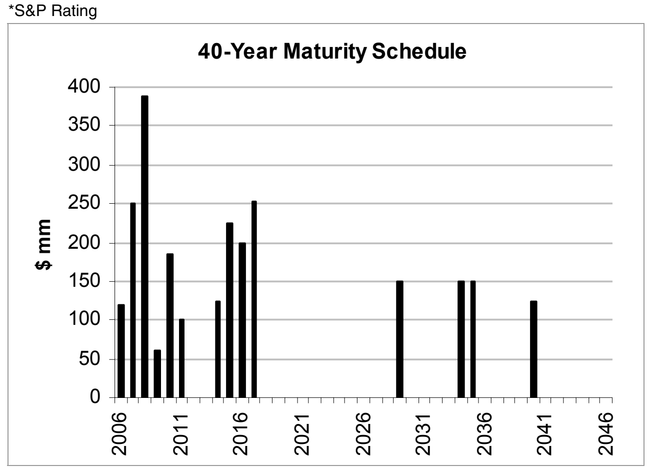



*S&P Rating




Source: Bloomberg

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|---|---|---|
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| UR - Negative | CW - Negative | UR - Negative |

**Index Weighting** – Terasen Inc. has a 0.02% weighting in the S&P/TSX Canadian Corporate Bond Index and a 0.59% weighting in the Utilities sector of the index.

**Company Description** – Terasen Inc. is a 100%-owned subsidiary of U.S.-based Kinder-Morgan Inc. (KMI). Terasen was acquired by KMI on Nov. 30, 2005. Terasen's businesses include natural gas distribution, and crude oil and refined products transportation. *Website:www.terasen.com*

**Recent Results** – Reflecting the seasonal nature of its gas distribution business, Terasen's net income was low at $2.5 million in Q3/06, marginally less than the $4.0 million in Q3/05. Of significance, FFO were materially lower at $21.3 million compared to $47.8 million in Q3/05. With lower cash flow and higher capital expenditure (due to the Trans Mountain system expansion), net cash flow was -$62.8 million with debt used to fill the void. No dividend was paid in Q3/06.

**Corporate Developments** – In recent filings with the SEC, KMI indicated possible divestitures of Terasen assets after completion of the management buyout to reduce KMI's leverage. Included in the list of potential asset sales are Terasen Gas and Trans Mountain to Kinder Morgan Energy Partners and 75% of Terasen Pipelines (Corridor).

**Capitalization and Liquidity** – Terasen had consolidated debt of $2.93 billion at Sept. 30, 2006, about $160 million less than at Dec. 31, 2005. Total debt to capital was 65.4% versus 68.6% at Dec. 31, 2005. At the end of Q3/06, Terasen had $82.8 million of cash and short-term investments, and $600 million of capacity under its consolidated lines of credit of $1.525 billion.

**Credit Ratings** – In response to the plan to take KMI private, DBRS has its ratings on Terasen Under Review with Negative Implications (confirmed on Sept. 11, 2006); Standard & Poor's has its ratings on KMI and its wholly owned subsidiaries, Terasen and Terasen Gas, on CreditWatch with Negative Implications and has indicated the rating on Terasen could go to sub-investment grade; and Moody's has the ratings on Terasen Under Review for possible downgrade and in a report of Nov. 14, 2006, indicated Terasen's senior unsecured debt would be rated Ba2 should the management buyout proceed as planned.

**Debt Recommendation** – We view Terasen as a more suitable buy for high yield investors. Terasen's generic credit spreads, not surprisingly, have been the worst performer in the pipeline sector. Year to date, the company's 5- and 10-year spreads are wider by 64 and 97 basis points, respectively, after being over 80 and 100 basis points wider, respectively, during the year.

# Terasen Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 9.750% | 17-Dec-06 | $20 | Retractable Debentures | 17-Dec-86 | NA | Non-callable | NA | $20 |
| Terasen Gas Inc. | 6.500% | 16-Oct-07 | $100 | MTNs | 16-Oct-00 | 75.0 bps | Make Whole + 18 bps | 05534ZAH9 | $100 |
| Terasen Gas Inc. | Floating | 24-Oct-07 | $150 | Floating Rate Notes | 24-Oct-05 | NA | Non-callable | 88078ZAD6 | $150 |
| Terasen Gas Inc. | 6.200% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Inc. | 6.300% | 1-Dec-08 | $200 | MTNs | 30-Nov-01 | NA | Make Whole + 27 bps | 11058ZAA8 | $200 |
| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Pipelines (Corridor) | 4.240% | 2-Feb-10 | $150 | Senior Unsecured | 1-Feb-05 | 65.5 bps | Make Whole + 14 bps | 88079VAA0 | $150 |
| Terasen Inc. | 5.560% | 15-Sep-14 | $125 | MTNs | 15-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Pipelines (Corridor) | 5.033% | 2-Feb-15 | $150 | Senior Unsecured | 1-Feb-05 | 81.1 bps | Make Whole + 19 bps | 88079VAB8 | $150 |
| Terasen Gas Inc. | 11.800% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.500% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.900% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.550% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Inc. | 8.000% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

## Ownership Structure

100% - Kinder Morgan Inc.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $580 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Corp. Lease Schedule (12/31/2005)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2006 | | 21.3 | |
| 2007 | | 20.2 | |
| 2008 | | 20.6 | |
| 2009 | | 19.3 | |
| 2010 | | 18.2 | |
| Thereafter | | 127.5 | |

## Credit Facilities ($mm)

| Company | Facility Size | Amount Available Q3/06 | Amount Available FY 2005 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. & subsidiaries | $1,175 | $534 | $375 | 2009 | Revolving Credit Facilities |
| Terasen Gas (Vancouver Island) | $350 | $66 | NA | Jan-11 | Revolving Credit Facility |

## Pension Summary

| | Pension Benefit Plans FY 2005 ($mm) | Pension Benefit Plans FY 2004 ($mm) | Other Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2004 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 344.4 | 298.0 | 81.9 | 67.3 |
| Plan Assets | 298.5 | 274.5 | - | - |
| Funded Status | (45.9) | (23.5) | (81.9) | (67.3) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 0.4 | 1.5 | (40.1) | (32.3) |
| Discount Rate | 6.00% | 6.25% | 6.00% | 6.25% |
| Expected Long-term Rate of of Return on Assets | 7.50% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.50% | 3.50% | NA | NA |

## Historical Ratings

**DBRS**

| Rating | Trend | Date |
|---|---|---|
| BBB (high) | UR-Negative | 30-May-06 |
| BBB (high) | Negative | 23-Dec-05 |
| A (low) | UR-Negative | 2-Aug-05 |
| A (low) | Stable | 4-Apr-00 |

**S&P**

| Rating | Trend | Date |
|---|---|---|
| BBB- | CreditWatch Negative | 30-May-06 |
| BBB- | Negative | 6-Dec-05 |
| BBB- | CreditWatch Negative | 2-Aug-05 |
| BBB- | Stable | 26-Jun-03 |
| BBB | CreditWatch Negative | 19-Nov-02 |
| BBB | Stable | 14-Nov-01 |

**Moody's**

| Rating | Trend | Date |
|---|---|---|
| Baa2 | Under Review - Negative | 30-May-06 |
| Baa2 | Stable | 19-Dec-05 |
| A3 | Under Review - Negative | 2-Aug-05 |
| A3 | Stable | 12-Dec-02 |
| A3 | Under Review - Negative | 19-Nov-02 |
| A3 | Stable | 8-Nov-01 |

**Analyst's Certification**

I, Laurie Conheady, 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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**Distribution of Ratings**

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 35% | 45% | 47% |
| Hold | Market Perform | 55% | 48% | 46% |
| Sell | Underperform | 10% | 7% | 7% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.
** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

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# Terasen Inc.

**May 18, 2007**
Brief Research Note

**Laurie Conheady**
(416) 359-4584
laurence.conheady@bmo.com

## DBRS Confirms Ratings and Assigns a Stable Outlook to Terasen Inc.

### Impact

Positive.

### Details & Analysis

DBRS this morning confirmed its ratings on Terasen Inc. with a Stable outlook. The confirmation removes the ratings from Under Review with Developing Implications, where they were placed on February 26, 2007, following the announcement that Fortis Inc. was to acquire the company. Fortis announced yesterday that the acquisition had been completed. The key factor in the ratings confirmation was the stronger credit profile of Terasen's new owner relative to its former owner, Kinder Morgan Inc. We note the Standard & Poor's and Moody's ratings on Terasen Inc. remain under review, with positive rating action likely from both agencies. We expect the Standard & Poor's issuer credit rating on Terasen Inc. to be upgraded and equalized with the rating on Fortis Inc. (BBB+/CW-Pos/--), as there are no structural, regulatory or legal ring-fencing measures to separate the two companies' ratings. If, however, the agency chooses to place a greater emphasis on Fortis' non-consolidated financial measures (an approach the agency has suggested it may take) and view Terasen Inc. as more of a stand-alone credit, the rating will still move higher from its sub-investment grade level. Moody's has advised that due to the absence of ring-fencing from Fortis, its rating on Terasen will tend to be equalized with that of Fortis or remain at its current level. Accordingly, Moody's believes the rating on Terasen is likely to remain Baa2 or increase to Baa1. We believe Fortis' acquisition of Terasen and its wholly owned gas utility, Terasen Gas Inc., is positive for the credit quality and spreads of both companies. The risks and uncertainties evident under its previous ownership are no longer a concern for bondholders, further positive rating actions are expected, and bond valuations for both companies are expected to tighten to move in line with its sector peers.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BB- | Baa2 |
| Stable | CW-Positive | UR-Positive |

**Analyst's Certification**

I, Laurie Conheady, 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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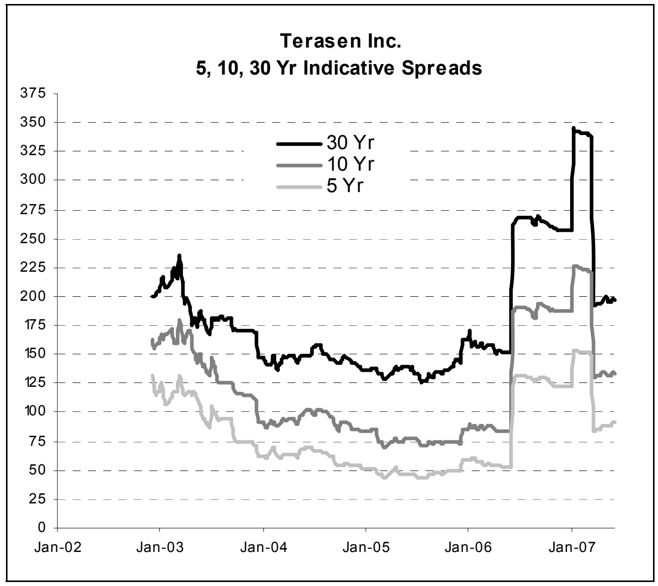
## Relative Value

**Recommendation** – We believe Fortis' acquisition of Terasen Inc. (Terasen) is positive for the credit quality and spreads of Terasen. The risks and uncertainties evident under its previous ownership are no longer a concern, positive rating actions are expected, and the company's bond valuations are expected to improve to move in line with its sector peers.

**Sector Value** – We believe Terasen offers good value at current spread levels. Its indicative spreads remain the widest of pipeline companies and while this was appropriate prior to the company's recent sale, it is not the case anymore.

**Credit Curve** – Terasen's limited debt issues means looking for better relative value along its credit curve is difficult, although on a comparable basis, the company's 10-year indicative spreads would appear to present better value relative to its 5-year spreads.

**Cash versus CDS** – There is currently no CDS market for Terasen's outstanding capital market issues.




Source: BMO Capital Markets / Source for Financial Estimates: BMO Capital Markets' equity analyst Chris Bolton's financial model.

## Risks

**External** – We do not view political risk in British Columbia as a material credit concern for Terasen. The government has not exhibited a tendency to intervene in regulatory determinations impacting its gas utility.

**LBO and M&A** – As a subsidiary of Fortis Inc., Terasen is not a LBO target. Further, although it cannot be completely ruled out, a LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base. With respect to M&A risk, we view this as low. Having recently acquired the company, we do not envisage Fortis would look to divest Terasen in the near term. Moreover, we expect Terasen's near-term focus will be on the integration with its new owner and not on M&A activity.

**Regulatory** – The regulatory risk faced by Terasen reflects the risk faced by Terasen Gas. The regulatory regime under which Terasen Gas operates is a positive feature of its business risk profile. Although continued low ROE is expected, the relatively transparent regulatory regime of the British Columbia Utilities Commission (BCUC) is not expected to present a major risk to the utility's credit profile. The demonstrated ability of Terasen's new owner to build good regulatory relationships also reduces regulatory risk.

**Trading Liquidity** – Despite the volatile movement in its spreads over the past 12 months, Terasen is an issuer that trades occasionally at best. Many investors have adopted a wait-and-see approach, which has limited supply in the market. The likely repayment of its $200 million maturing issue in December 2008 will further reduce liquidity.

**New Issuance** – We do not expect Terasen to undertake further capital market issues given Fortis' intention to repay Terasen's existing debt issue on maturity.

## Credit Profile

**Company Financials** – Terasen's Q1/07 results were adversely impacted by a $441.9 million one-time charge related to the impairment of goodwill within the petroleum transportation business. Of importance was the earnings from the natural gas distribution business given it will represent the bulk of its operations going forward. Earnings for this business were down 1% to $54.8 million compared to Q1/06 and FFO was similar to that received in Q1/06. At year-end 2006, Terasen had available credit lines of $501 million.

**Company Fundamentals** – With the recent divestiture of its petroleum assets, the stand-alone credit profile of Terasen largely reflects the credit profile of its principle subsidiary, Terasen Gas. The credit profile of Terasen Gas is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex** – In early 2007, Terasen estimated capex for the year to be $1.232 billion, but the bulk of this is at subsidiaries and projects it now no longer owns. Remaining capex is estimated at about $280 million, although we note this may move higher with the company filing an application on June 5, 2007, to construct a natural gas storage facility with an estimated cost of $175–200 million.

**Credit Ratings** – DBRS confirmed its ratings on Terasen with a Stable outlook on May 18, 2007. The key factor in the confirmation was the stronger credit profile of Terasen's new owner relative to its former owner, Kinder Morgan Inc. We note the Standard & Poor's and Moody's ratings on Terasen remain under review, with positive rating action likely. We expect the Standard & Poor's issuer credit rating on Terasen to be upgraded and possibly equalized with the rating on Fortis (BBB+/CW-Pos/--). Moody's has advised that due to the absence of ring-fencing from Fortis, its rating on Terasen will tend to be equalized with that of Fortis or remain at its current level. Accordingly, Moody's believes the rating is likely to remain Baa2 or increase to Baa1.

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BB- | Baa2 |
| Stable | CW-Pos | UR-Pos |

**Disclosures:** 9, 10C

# Terasen Inc.

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| Terasen Gas Inc. | 10.750% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
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| Terasen Gas Inc. | 10.300% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.950% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
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| 2008 | | 21.1 | |
| 2009 | | 19.5 | |
| 2010 | | 18.3 | |
| 2011 | | 18.6 | |
| Thereafter | | 116.9 | |

## Credit Facilities ($mm)

| Company | Facility Size | Amount Available FY 2006 | Amount Available FY 2005 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. & subsidiaries* | $1,175 | $501 | $375 | 2009 | Revolving Credit Facilities |

* On Jan. 23, 2007, Terasen Pipelines (Corridor) increased its credit facility to $375 million from $225 million.

## Pension Summary

| | Pension Benefit Plans FY 2006 ($mm) | Pension Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2005 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 370.0 | 344.4 | 89.7 | 81.9 |
| Plan Assets | 334.7 | 298.5 | - | - |
| Funded Status | (35.3) | (45.9) | (89.7) | (81.9) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 1.2 | 0.4 | (48.9) | (40.1) |
| Discount Rate | 5.00% | 6.00% | 6.00% | 6.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.84% | 3.50% | NA | NA |

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| BBB (high) | Stable | 18-May-07 | BB- | CreditWatch Positive | 26-Feb-07 | Baa2 | Under Review - Positive | 8-Mar-07 |
| BBB (high) | UR-Developing | 26-Feb-07 | BB- | Stable | 5-Jan-07 | Baa2 | Under Review - Negative | 30-May-06 |
| BBB (high) | UR-Negative | 30-May-06 | BBB- | CreditWatch Negative | 30-May-06 | Baa2 | Stable | 19-Dec-05 |
| BBB (high) | Negative | 23-Dec-05 | BBB- | Negative | 6-Dec-05 | A3 | Under Review - Negative | 2-Aug-05 |
| A (low) | UR-Negative | 2-Aug-05 | BBB- | CreditWatch Negative | 2-Aug-05 | A3 | Stable | 12-Dec-02 |
| A (low) | Stable | 4-Apr-00 | BBB- | Stable | 26-Jun-03 | A3 | Under Review - Negative | 19-Nov-02 |
| | | | BBB | CreditWatch Negative | 19-Nov-02 | A3 | Stable | 8-Nov-01 |
| | | | BBB | Stable | 14-Nov-01 | | | |

**Analyst's Certification**

I, Laurie Conheady, 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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**Distribution of Ratings**

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 38% | 47% | 47% |
| Hold | Market Perform | 52% | 45% | 46% |
| Sell | Underperform | 10% | 8% | 7% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.

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**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

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## Relative Value

**Recommendation** – The credit profile of Terasen Inc. (Terasen) largely reflects that of its low-risk gas utility, Terasen Gas Inc. (Terasen Gas), coupled with its access to the financial and management resources of Fortis Inc. Such a combination significantly reduces the risk for its bondholders. We recommend an overweight exposure to Terasen, although we acknowledge the limited opportunity to buy its paper.

**Sector Value** – We believe Terasen offers value at current spread levels. Its indicative spreads remain wide versus utility holding company peers and do not accurately encapsulate the significant reduction in its risk profile in the past year or more.

**Credit Curve** – Terasen's limited debt issues mean the ability to seek better relative value along its curve is not possible.

## Risks

**External** – We do not view political risk in British Columbia as a material credit concern for Terasen. The government has not exhibited a tendency to intervene in the regulatory determinations impacting its principle gas utility, Terasen Gas.

**LBO** – As a subsidiary of Fortis, Terasen is not an LBO target. Although it cannot be ruled out, an LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A** – We view M&A risk as low. We do not expect Fortis to look to divest Terasen in the near term. Moreover, we expect Terasen's near-term focus will be on organic growth opportunities within its gas utilities.

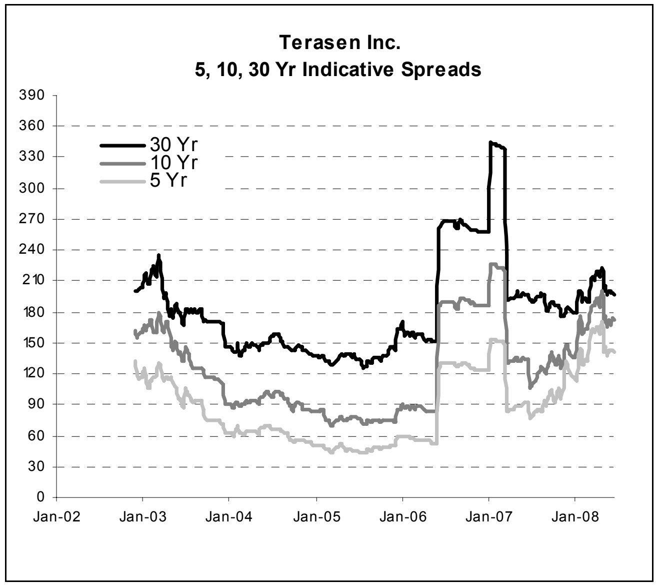
**Regulatory** – Regulatory risk faced by Terasen reflects the risk faced by Terasen Gas. Although allowed ROE is low, the relatively transparent regime of the British Columbia Utilities Commission is not expected to present a major risk to the utility's credit profile. The demonstrated ability of Fortis to build good regulatory relationships also reduces the risk.

**Trading Liquidity** – Terasen's debt issues trade occasionally. Many investors have a buy-and-hold approach to the paper, which limits supply. The likely repayment of its $200 million December 2008 issue on maturity will further reduce liquidity.

**New Issuance** – We do not expect Terasen to undertake any further capital market issues given Fortis' intention to repay Terasen's existing debt issues on maturity. Future issuance from the Terasen group will come from its gas utilities, Terasen Gas and Terasen Gas (Vancouver Island) Inc.

## Credit Profile

**Company Financials** – Terasen's earnings of $52.4 million in Q1/08 compared with a loss of $396.4 million in Q1/07. The turnaround in earnings is mainly due to the sale of the company's pipelines businesses in Q2/07 and a goodwill impairment charge taken in Q1/07. The company's natural gas distribution businesses, the primary drivers of earnings, recorded a 7.5% increase in earnings in Q1/08 to $58.9 million. Higher earnings before discontinued operations contributed to a $23.7 million increase in FFO to $81.3 million in Q1/08. However, the cash flows were insufficient to fund capex and a $50 million dividend (nil in Q1/07). The cash flow shortfall was met with positive working capital and proceeds from the sale of land. Liquidity in Q1/08 was adequate with the company's $100 million credit facility fully available, and leverage was 67.5%.



Source: BMO Capital Markets

**Company Fundamentals** – The stand-alone credit profile of Terasen largely reflects the credit profile of its principal subsidiary, Terasen Gas. Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex** – Terasen has estimated consolidated capex in 2008 of $263.7 million. Major capex includes construction of the Mt. Hayes LNG project and Squamish to Whistler pipeline, and replacement of the Vancouver low pressure system.

**Credit Ratings** – DBRS last confirmed its ratings on Terasen on Nov. 30, 2007. The confirmation reflects the low business-risk profile of its regulated subsidiaries, and their strong and stable cash flow contributions to Terasen. It also reflects that Terasen's ownership is now held by Fortis, an entity with a stronger credit profile than the previous owner. Moody's confirmed its rating on July 30, 2007, after placing the ratings under review for possible upgrade on March 8, 2007. The agency's outlook reflects its expectation the issuer will remain a holding company for regulated gas distribution utilities and that its holding company debt will be fully retired in the medium term. In its last rating summary of December 21, 2008, Standard & Poor's advised that it sees little prospect for a ratings improvement in the near term. The ratings could be lowered or a change in outlook to negative could occur if direct debt levels do not decline as scheduled, operational performance suffers or the dividends from the subsidiaries are materially restricted.

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BBB+ | Baa2 |
| Stable | Stable | Stable |

**Disclosures:** 9

# Terasen Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Inc. | 6.30% | 01-Dec-08 | $200 | MTNs | 30-Nov-01 | NA | Make Whole + 27 bps | 11058ZAA8 | $200 |
| Terasen Gas Inc. | 10.75% | 08-Jun-09 | $60 | Debentures | 08-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Inc. | 5.56% | 15-Sep-14 | $125 | MTNs | 15-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF1 | $250 |
| Terasen Gas (Vancouver Island) Inc. | 6.05% | 15-Feb-38 | $250 | Debentures | 15-Feb-08 | 183.0 bps | Make Whole + 46 bps | 88100BAA7 | $250 |
| Terasen Gas Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole + 40 bps | 88078ZAG9 | $250 |
| Terasen Inc. | 8.00% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

## Ownership Structure

100% - Fortis Inc.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $350 | 24-Apr-08 | 24-May-10 | MTNs |

## Corp. Lease Schedule (12/31/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2008 | | 18.4 | |
| 2009 | | 17.1 | |
| 2010 | | 15.8 | |
| 2011 | | 15.5 | |
| 2012 | | 15.1 | |
| 2013 and thereafter | | 93.3 | |

## Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q1/08 | Amount Available Q4/07 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. | $100 | $100 | $100 | 2009 | Revolving Credit Facility |

* The capacity of Terasen Inc.'s credit agreement was reduced to $180 million in Q2/07 and reduced further to $100 million in Q3/07.

## Pension Summary

| | Pension Benefit Plans FY 2007 ($mm) | Pension Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2007 ($mm) | Other Benefit Plans FY 2006 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 280.8 | 370.0 | 79.4 | 89.7 |
| Plan Assets | 261.2 | 334.7 | - | - |
| Funded Status | (19.6) | (35.3) | (79.4) | (89.7) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | (3.9) | (7.8) | (50.7) | (48.9) |
| Discount Rate | 5.00% | 5.00% | 5.00% | 5.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.77% | 3.84% | NA | NA |

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| BBB (high) | Stable | 18-May-07 | BBB+ | Stable | 19-Jun-07 | Baa2 | Stable | 30-Jul-07 |
| BBB (high) | UR-Dev | 26-Feb-07 | BB- | CW-Pos | 26-Feb-07 | Baa2 | UR-Pos | 8-Mar-07 |
| BBB (high) | UR-Neg | 30-May-06 | BB- | Stable | 5-Jan-07 | Baa2 | UR-Neg | 30-May-06 |
| BBB (high) | Negative | 23-Dec-05 | BBB- | CW-Neg | 30-May-06 | Baa2 | Stable | 19-Dec-05 |
| A (low) | UR-Neg | 2-Aug-05 | BBB- | Negative | 6-Dec-05 | A3 | UR-Neg | 2-Aug-05 |
| A (low) | Stable | 4-Apr-00 | BBB- | CW-Neg | 2-Aug-05 | A3 | Stable | 12-Dec-02 |
| | | | BBB- | Stable | 26-Jun-03 | A3 | NR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 19-Nov-02 | A3 | Stable | 8-Nov-01 |
| | | | BBB | Stable | 14-Nov-01 | | | |

### Analyst's Certification

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| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 38% | 42% | 49% |
| Hold | Market Perform | 53% | 52% | 46% |
| Sell | Underperform | 9% | 6% | 5% |

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Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
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# Terasen Inc.

**July 31, 2007**
Brief Research Note

**Laurie Conheady**
(416) 359-4584
laurence.conheady@bmo.com

## Moody's Confirms Baa2 Rating

### Impact

Neutral

### Details & Analysis

Moody's last night confirmed its Baa2 senior unsecured and Baa3 subordinate unsecured ratings on Terasen Inc. and assigned a Stable outlook. The ratings had been Under Review for a possible upgrade since March 8, 2007 following Fortis Inc.'s announced acquisition of Terasen Inc. on February 26, 2007. The transaction closed on May 17. The rating action is in line with our expectations as outlined in our Quarterly Ratings Outlook Review, published July 18. As part of the rating action, Moody's affirmed its ratings on Terasen Inc.'s subsidiary, Terasen Gas Inc. at A2 (senior secured) and A3 (senior unsecured).

We note with interest two aspects of the rating confirmation. The first is that although the agency views Terasen Inc. (and Terasen Gas Inc.) to be financially and operationally independent from their ultimate parent, Fortis Inc., the agency believes the Terasen Inc. rating will tend to be equalized with that of its parent (although the agency does not publicly rate Fortis Inc.). Given Moody's view that there is a close link between Terasen Inc. and Fortis Inc., it is not a stretch to suggest then that Moody's views the credit quality of Fortis Inc. as equivalent to a Baa2 credit. This is a notch below DBRS at BBB (high) and two notches below the recently upgraded rating by Standard & Poor's of A-.

The second aspect of interest is that Moody's flagged the relatively heavy debt maturity schedule at Terasen Gas Inc. over the next 12 months as a notable risk to the Terasen Inc. rating. Of particular interest in the current funding environment was the agency's comment that if Terasen Gas Inc. is unable to finance either of its October 2007 debt maturities totalling $250 million, Terasen Gas Inc. and Terasen Inc. could experience either a negative outlook or a rating downgrade.

### Senior Unsecured Debt Ratings

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BBB+ | Baa2 |
| Stable | Stable | Stable |

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**Analyst's Certification**

I, Laurie Conheady, 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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**Additional Matters**

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# Terasen Inc.



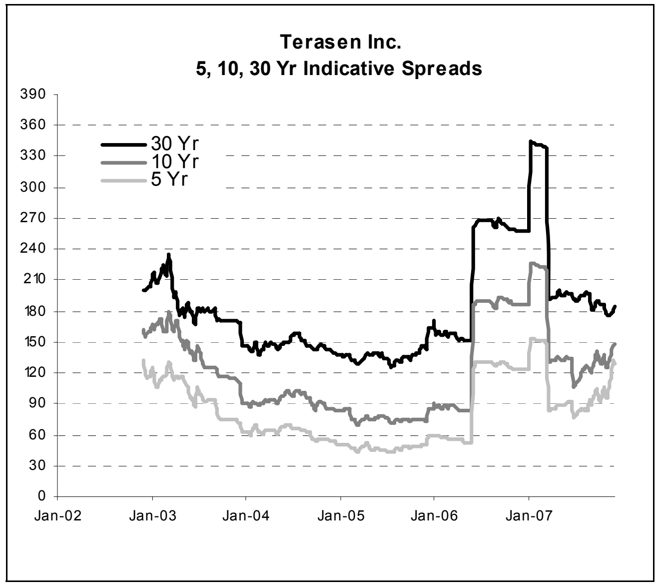
## Relative Value

**Recommendation –** We believe Fortis' acquisition of Terasen Inc. (Terasen) was positive for Terasen's credit quality and spreads. As expected, positive rating actions have resulted, and the company's bond valuations have improved and moved more into line with sector peers. We recommend an overweight exposure to Terasen should a buying opportunity arise.

**Sector Value –** We believe Terasen offers good value at current spread levels. Its indicative spreads remain wide versus pipeline company peers and although this was appropriate prior to the company's sale earlier this year, it is not the case now.

**Credit Curve –** Terasen's limited debt issues mean the ability to seek better relative value along its credit curve is difficult, although on a comparable basis, the company's 2014 debt issue looks to offer better value than its shorter-dated paper.

**Cash versus CDS –** There is currently no CDS market for Terasen's outstanding capital market issues.




Source: BMO Capital Markets

## Risks

**External –** We do not view political risk in British Columbia as a material credit concern for Terasen. The government has not exhibited a tendency to intervene in regulatory determinations impacting its gas utility, Terasen Cos. Inc.

**LBO –** As a subsidiary of Fortis, Terasen is not a LBO target. Although it cannot be ruled out, a LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A –** We view M&A risk as low. Having recently acquired the company, we do not expect that Fortis would look to divest Terasen in the near term. Moreover, we expect Terasen's near-term focus will be on the integration with its new owner.

**Regulatory –** Regulatory risk reflects the risk faced by Terasen Gas. Although allowed ROE is low, the relatively transparent regime of the British Columbia Utilities Commission is not expected to present a major risk to the utility's credit profile. The demonstrated ability of Fortis to build good regulatory relationships also reduces the risk.

**Trading Liquidity –** Terasen's debt issues trade occasionally. Many investors have a buy-and-hold approach to the paper, which limits supply. The likely repayment of its $200 million December 2008 issue on maturity will further reduce liquidity.

**New Issuance –** We do not expect Terasen to undertake further capital market issues given Fortis' intention to repay Terasen's existing debt issues on maturity.

## Credit Profile

**Company Financials –** Terasen recorded a net loss of $9.3 million in Q3/07 versus a loss of $13.4 million for Q3/06. The loss largely reflects the seasonality of earnings of the company's gas distribution business. Terasen's loss of $414.4 million for the first nine months of 2007 is, however, due primarily to the sale of its pipelines businesses in Q2/07 and a goodwill impairment charge of $441.9 million taken in Q1/07. FFO of $13 million in Q3/07 was up from $0.1 million in Q3/06, but insufficient to fund capex, with the cash flow shortfall largely met with increased debt commitments, but supplemented by an advance from Fortis. Despite reducing the size of its credit facility to $100 million in Q3/07, liquidity remains adequate and leverage was 68%.

**Company Fundamentals –** With the divestiture of its petroleum assets in early 2007, the stand-alone credit profile of Terasen largely reflects the credit profile of its principal subsidiary, Terasen Gas. Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex –** Terasen's capex for 2007 is expected to be $250–300 million. BMO Capital Markets equity research estimates capex for 2008 of $230 million. We note capex is likely to be higher than normal in the next few years following the receipt of conditional regulatory approval on Nov. 15, 2007, for Terasen Gas (Vancouver Island) Inc. to construct and operate a natural gas storage facility on Vancouver Island costing $175–200 million.

**Credit Ratings –** After many years of uncertainty, Terasen now has stable ratings. DBRS last confirmed its ratings on Terasen on Nov. 30, 2007. The confirmation reflects the low business risk profile of its regulated subsidiaries, and their strong and stable cash flow contributions to Terasen. It also reflects the fact that Terasen's ownership is now held by Fortis, an entity with a stronger credit profile than the previous owner. Moody's confirmed its rating on July 30, 2007, after placing the company's ratings under review for possible upgrade on March 8, 2007. As expected, on June 19, 2007, Standard & Poor's upgraded its rating on Terasen by five notches, after the acquisition by Fortis. In assigning the new rating, Standard & Poor's advised that it views Terasen Inc.'s credit quality on a stand-alone basis to be low investment grade.

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BBB+ | Baa2 |
| Stable | Stable | Stable |

**Disclosures:** 9, 10C

# Terasen Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 6.20% | 2-Jun-08 | $188 | MTNs | 21-Oct-97 | 80.0 bps | Non-callable | 05534ZAC0 | $188 |
| Terasen Inc. | 6.30% | 1-Dec-08 | $200 | MTNs | 30-Nov-01 | NA | Make Whole + 27 bps | 11058ZAA8 | $200 |
| Terasen Gas Inc. | 10.75% | 8-Jun-09 | $60 | Debentures | 8-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Inc. | 5.56% | 15-Sep-14 | $125 | MTNs | 15-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 3-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 1-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 2-Oct-37 | $250 | MTNs | 2-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF14 | $250 |
| Terasen Inc. | 8.00% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

## Ownership Structure

100% - Fortis Inc.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $700 | $330 | 8-Dec-05 | 8-Jan-08 | MTNs |

## Corp. Lease Schedule (9/30/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2007/08 | | 18.4 | |
| 2008/09 | | 17.4 | |
| 2009/10 | | 16.1 | |
| 2010/11 | | 15.6 | |
| 2011/12 | | 15.3 | |
| 2012 and thereafter | | 95.0 | |

## Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q3/07 | Amount Available Q2/07 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. | $100 | $100 | $177 | 2009 | Revolving Credit Facility |

* The capacity of Terasen Inc.'s credit agreement was reduced to $180 million in Q2/07 and reduced further to $100 million in Q3/07. Available capacity under the facilities has been reduced by outstanding letters of credit.

## Pension Summary

| | Pension Benefit Plans FY 2006 ($mm) | Pension Benefit Plans FY 2005 ($mm) | Other Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2005 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 370.0 | 344.4 | 89.7 | 81.9 |
| Plan Assets | 334.7 | 298.5 | - | - |
| Funded Status | (35.3) | (45.9) | (89.7) | (81.9) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | 1.2 | 0.4 | (48.9) | (40.1) |
| Discount Rate | 5.00% | 6.00% | 6.00% | 6.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.50% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.84% | 3.50% | NA | NA |

## Historical Ratings

**DBRS**

| Rating | Trend | Date |
|---|---|---|
| BBB (high) | Stable | 18-May-07 |
| BBB (high) | UR-Developing | 26-Feb-07 |
| BBB (high) | UR-Negative | 30-May-06 |
| BBB (high) | Negative | 23-Dec-05 |
| A (low) | UR-Negative | 2-Aug-05 |
| A (low) | Stable | 4-Apr-00 |

**S&P**

| Rating | Trend | Date |
|---|---|---|
| BBB+ | Stable | 19-Jun-07 |
| BB- | BBB+ | 26-Feb-07 |
| BB- | Stable | 5-Jan-07 |
| BBB- | CreditWatch Negative | 30-May-06 |
| BBB- | Negative | 6-Dec-05 |
| BBB- | CreditWatch Negative | 2-Aug-05 |
| BBB- | Stable | 26-Jun-03 |
| BBB | CreditWatch Negative | 19-Nov-02 |
| BBB | Stable | 14-Nov-01 |

**Moody's**

| Rating | Trend | Date |
|---|---|---|
| Baa2 | Stable | 30-Jul-07 |
| Baa2 | Under Review - Positive | 8-Mar-07 |
| Baa2 | Under Review - Negative | 30-May-06 |
| Baa2 | Stable | 19-Dec-05 |
| A3 | Under Review - Negative | 2-Aug-05 |
| A3 | Stable | 12-Dec-02 |
| A3 | Under Review - Negative | 19-Nov-02 |
| A3 | Stable | 8-Nov-01 |

**Analyst's Certification**

I, Laurie Conheady, 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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Disclosure 9: BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

Disclosure 10: This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Non-Securities Related Services.

**Distribution of Ratings**

| Rating Category | BMO Rating | BMO Universe | BMO I.B. Clients * | First Call Universe ** |
|---|---|---|---|---|
| Buy | Outperform | 38% | 42% | 49% |
| Hold | Market Perform | 53% | 52% | 46% |
| Sell | Underperform | 9% | 6% | 5% |

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.

** Reflects rating distribution of all North American equity research analysts.

**Ratings Key**

We use the following ratings system definitions:
OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

**Dissemination of Research**

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

**Additional Matters**

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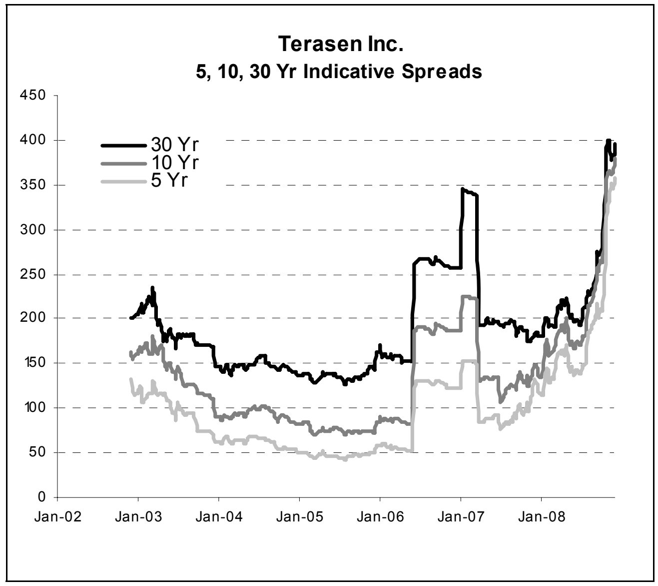
## Relative Value

**Recommendation** – The credit profile of Terasen Inc. (Terasen) largely reflects that of its low-risk gas utility, Terasen Gas Inc. (Terasen Gas), coupled with its access to the financial and management resources of Fortis Inc. Such a combination significantly reduces the risk for its bondholders. We believe an overweight exposure to Terasen is appropriate, although we acknowledge the limitations on gaining exposure to the credit. The limited opportunity has not been helped by the recent maturity of the company's largest debt issue.

**Sector Value** – We believe Terasen offers value at current spread levels. Its indicative spreads remain wide versus utility holding company peers and Fortis Inc., and do not accurately reflect its lower risk profile in the past year or more.

**Credit Curve** – Terasen's limited debt issues mean the ability to seek better relative value along its curve is not possible.



Source: BMO Capital Markets

## Risks

**External** – We do not view political risk in British Columbia as a material credit concern for Terasen. The government has not exhibited a tendency to intervene in the regulatory determinations impacting its principle gas utility, Terasen Gas.

**LBO** – As a subsidiary of Fortis, Terasen is not an LBO target. Although it cannot be ruled out, an LBO of Fortis is viewed as unlikely given its largely regulated operations (about 90% of cash flows) and widely held investor base.

**M&A** – We view M&A risk as low. We do not expect Fortis to look to divest Terasen in the near term. Moreover, we expect Terasen's near-term focus will be on organic growth opportunities within its gas utilities.

**Regulatory** – Regulatory risk faced by Terasen reflects the risk faced by Terasen Gas. Although allowed ROE is low, the relatively transparent regime of the British Columbia Utilities Commission is not expected to present a major risk to the utility's credit profile. The demonstrated ability of Fortis to build good regulatory relationships also reduces the risk.

**Trading Liquidity** – Terasen's debt issues trade occasionally. Many investors have a buy-and-hold approach to the paper, which limits supply. The maturity of its $200 million on Dec. 1, 2008, has further reduced liquidity, leaving Terasen with just one senior debt issue outstanding.

**New Issuance** – We do not expect Terasen to undertake any further capital market issues given Fortis' intention to repay Terasen's existing debt issues on maturity. Future issuance from the Terasen group will come from its gas utilities, Terasen Gas and Terasen Gas (Vancouver Island) Inc.

## Credit Profile

**Company Financials** – Reflecting the seasonality of its operations, Terasen's recorded a net loss of $1 million in Q3/08, down from a loss of $9.3 million in Q3/07. The better earnings results was mainly due to the settlement with Revenu Québec and Canada Revenue Agency related to amounts owing as a result of retroactive amending Quebec tax legislation. For the first nine months of 2008, better earnings pushed Terasen's FFO to $134.9 million, double the $68.3 million in the first nine months of 2007. Higher capex of $145 million in the first three quarters of 2008, compared to $118.1 million in 2007, and a dividend of $77 million, versus no dividend in 2007, meant FFO were insufficient to meet capital outlays. The cash flow shortfall was met through positive working capital adjustments, higher short-term notes and advances from Fortis Inc. Liquidity in Q3/08 was adequate with the company's $100 million credit facility fully available, and leverage of 70% was up two percent on year-end 2007.

**Company Fundamentals** – The stand-alone credit profile of Terasen largely reflects the credit profile of its principal subsidiary, Terasen Gas. Terasen Gas' credit profile is underpinned by the generally supportive regulatory regime governing its low-risk gas distribution business, its monopoly position serving over 95% of the natural gas consumers in British Columbia and its efficient operations.

**Capex** – Terasen has estimated consolidated capex in 2008 of $263.7 million. Gross capex by the Terasen group is estimated over the next five years to exceed $1 billion.

**Credit Ratings** – DBRS last confirmed its ratings on Terasen on Nov. 30, 2007. The confirmation reflects the low business-risk profile of its regulated subsidiaries, and their strong and stable cash flow contributions to Terasen. It also reflects Terasen's ownership by Fortis.

Moody's outlook on Terasen reflects its expectation the issuer will remain a holding company for regulated gas distribution utilities and that its holding company debt will be fully retired in the medium term.

Standard & Poor's advised that it sees little prospect for a ratings improvement in the near term. The ratings could be lowered or the outlook changed to Negative if direct debt levels do not decline, operational performance suffers or dividends from the subsidiaries are restricted.

| DBRS | S&P | Moody's |
|---|---|---|
| BBB (high) | BBB+ | Baa2 |
| Stable | Stable | Stable |

**Disclosures:** 9, 10C

# Terasen Inc.

## Maturity Schedule

| Company | Coupon | Maturity | Amount ($mm) | Instrument | Issue Date | Issue Spread | Callable | CUSIP | Outstanding ($mm) |
|---|---|---|---|---|---|---|---|---|---|
| Terasen Gas Inc. | 10.75% | 08-Jun-09 | $60 | Debentures | 08-Jun-89 | NA | Make Whole + 40 bps | 457452AH3 | $60 |
| Terasen Inc. | 5.56% | 15-Sep-14 | $125 | MTNs | 15-Sep-04 | 93.0 bps | Make Whole + 23 bps | 88079ZAB9 | $125 |
| Terasen Gas Inc. | 11.80% | 30-Sep-15 | $75 | Mortgage | 03-Dec-90 | NA | Non-callable | 05534RAA2 | $75 |
| Terasen Gas Inc. | 10.30% | 30-Sep-16 | $200 | Mortgage | 21-Nov-91 | 104.0 bps | Make Whole + 35 bps | 05534RAB0 | $200 |
| Terasen Gas Inc. | 6.95% | 21-Sep-29 | $150 | MTNs | 21-Sep-99 | 112.0 bps | Make Whole + 28 bps | 05534ZAF3 | $150 |
| Terasen Gas Inc. | 6.50% | 01-May-34 | $150 | MTNs | 29-Apr-04 | 127.0 bps | Make Whole + 31 bps | 88078ZAB0 | $150 |
| Terasen Gas Inc. | 5.90% | 26-Feb-35 | $150 | MTNs | 25-Feb-05 | 118.0 bps | Make Whole + 29 bps | 88078ZAC8 | $150 |
| Terasen Gas Inc. | 5.55% | 25-Sep-36 | $120 | MTNs | 25-Sep-06 | 136.0 bps | Make whole + 34 bps | 88078ZAE4 | $120 |
| Terasen Gas Inc. | 6.00% | 02-Oct-37 | $250 | MTNs | 02-Oct-07 | 148.0 bps | Make Whole + 37 bps | 88078ZAF1 | $250 |
| Terasen Gas (Vancouver Island) Inc. | 6.05% | 15-Feb-38 | $250 | Debentures | 15-Feb-08 | 183.0 bps | Make Whole + 46 bps | 88100BAA7 | $250 |
| Terasen Gas Inc. | 5.80% | 13-May-38 | $250 | MTNs | 13-May-08 | 163.0 bps | Make Whole + 40 bps | 88078ZAG9 | $250 |
| Terasen Inc. | 8.00% | 19-Apr-40 | $125 | Subordinated Debentures | 19-Apr-00 | 235.0 bps | Make Whole + 55 bps | 05534KAA7 | $125 |

## Ownership Structure

100% - Fortis Inc.

## Shelf Prospectus ($mm)

| Company | Type | Amount | Remaining | Date | Expiry | Instruments |
|---|---|---|---|---|---|---|
| Terasen Gas Inc. | Shelf | $600 | $350 | 24-Apr-08 | 24-May-10 | MTNs |

## Corp. Lease Schedule (12/31/2007)

| ($mm) Year | Capital Lease Payments | Operating Lease Payments | Lease Receipts |
|---|---|---|---|
| 2008 | | 18.4 | |
| 2009 | | 17.1 | |
| 2010 | | 15.8 | |
| 2011 | | 15.5 | |
| 2012 | | 15.1 | |
| 2013 and thereafter | | 93.3 | |

## Credit Facilities ($mm)

| Company | Facility Size* | Amount Available Q3/08 | Amount Available Q2/08 | Maturity | Type |
|---|---|---|---|---|---|
| Terasen Inc. | $100 | $99.9 | $99.8 | 2009 | Revolving Credit Facility |

* The capacity of Terasen Inc.'s credit agreement was reduced to $180 million in Q2/07 and reduced further to $100 million in Q3/07.

## Pension Summary

| | Pension Benefit Plans FY 2007 ($mm) | Pension Benefit Plans FY 2006 ($mm) | Other Benefit Plans FY 2007 ($mm) | Other Benefit Plans FY 2006 ($mm) |
|---|---|---|---|---|
| Accrued Benefit Obligation | 280.8 | 370.0 | 79.4 | 89.7 |
| Plan Assets | 261.2 | 334.7 | - | - |
| Funded Status | (19.6) | (35.3) | (79.4) | (89.7) |
| Accrued Benefit Asset (Liability) Net of Valuation Allowance | (3.9) | (7.8) | (50.7) | (48.9) |
| Discount Rate | 5.00% | 5.00% | 5.00% | 5.00% |
| Expected Long-term Rate of of Return on Assets | 7.25% | 7.25% | NA | NA |
| Rate of Future Increase in Compensation (ABO) | 3.77% | 3.84% | NA | NA |

## Historical Ratings

| DBRS Rating | DBRS Trend | DBRS Date | S&P Rating | S&P Trend | S&P Date | Moody's Rating | Moody's Trend | Moody's Date |
|---|---|---|---|---|---|---|---|---|
| BBB (high) | Stable | 18-May-07 | BBB+ | Stable | 19-Jun-07 | Baa2 | Stable | 30-Jul-07 |
| BBB (high) | UR-Dev | 26-Feb-07 | BB- | CW-Pos | 26-Feb-07 | Baa2 | UR-Pos | 08-Mar-07 |
| BBB (high) | UR-Neg | 30-May-06 | BB- | Stable | 05-Jan-07 | Baa2 | UR-Neg | 30-May-06 |
| BBB (high) | Negative | 23-Dec-05 | BBB- | CW-Neg | 30-May-06 | Baa2 | Stable | 19-Dec-05 |
| A (low) | UR-Neg | 02-Aug-05 | BBB- | Negative | 06-Dec-05 | A3 | UR-Neg | 02-Aug-05 |
| A (low) | Stable | 04-Apr-00 | BBB- | CW-Neg | 02-Aug-05 | A3 | Stable | 12-Dec-02 |
| | | | BBB- | Stable | 26-Jun-03 | A3 | NR-Neg | 19-Nov-02 |
| | | | BBB | CW-Neg | 19-Nov-02 | A3 | Stable | 08-Nov-01 |
| | | | BBB | Stable | 14-Nov-01 | | | |

**Analyst's Certification**

I, Laurie Conheady, 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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|---|---|---|---|---|
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**Terasen Inc. (senior unsecured BBB(high)/ BBB-pi/ Baa2)** ratings remain under review or with a negative trend at Moody's and DBRS, as a result of the proposed Kinder Morgan Inc. (KMI) management buyout transaction. S&P's unsolicited rating is also on CreditWatch Negative. The management buyout of Terasen Inc.'s parent KMI appears to be on target for completion soon, as it has obtained Board approval, and the stockholders vote is scheduled to take place on December 19th. In the U.S., KMI's bondholders have been granted a share in the security being made available to the acquisition financing lenders, which consists of the shares and assets of KMI's U.S.-based subsidiaries. In Canada, it appears (but in our understanding is not crystal clear) that Terasen Inc. bondholders are carved out of the proposed security package. We understand that the documentation governing the senior secured credit facilities that will provide the debt portion of the buyout financing has not been finalized. We expect that this documentation, when made public, will clarify the position of Terasen Inc. bondholders. Until then, we are unable to come to a clear view on Terasen Inc.'s outstanding debt. However, we think the underlying operations of the subsidiaries remain sound. **Terasen Gas Inc. (senior unsecured A/ BBBpi/ A3)** debt remains good value in our view, since the regulatory ringfencing in place effectively insulates it from the turmoil of the leveraged buyout. Trans Mountain Pipeline has recently received key approvals from the NEB, for a crucial expansion, and for a new five-year incentive tolling agreement. The Corridor and Express pipelines also are performing well. However, given the buyout investors' announced intention to sell the Trans Mountain Pipeline system to Kinder Morgan Energy Partners LP (KMP), and as well, to consider the sale of 75% of the Corridor Pipeline, Terasen's 33% interest in the Express/Platte system, and/or a sale of Terasen Gas, we anticipate that Terasen Inc. spreads may remain at roughly current levels, with thin liquidity, until the buyout investors' intentions for Terasen Inc.'s assets are made clear.

<u>Terasen Gas</u>

Terasen Gas' Q3 earnings results, a net loss of $13 million, was a little worse than the $9 million loss in 2005, but flat to Q3 of 2003, and less than the typical level of Q3 losses in the years 2000 through 2002. Increased bad debt expenses in Q3, which management believes will be non-recurring, accounted for most of the increased loss this year compared to 2005. Year to date, earnings are down from 2005, to $48 million from $60 million, due mainly to the $14.5 million provision taken in Q2 for the retroactive tax amending legislation introduced by the Province of Québec. So far this year, Terasen Gas has paid no dividends to Terasen Inc., compared to $45 million in the first nine months of 2005. Terasen Inc. has paid no dividends in 2006, compared to $71 million in the first nine months of 2005.

<u>Trans Mountain Pipeline</u>

Terasen Inc. does not report Trans Mountain results separately, though Terasen did say that earnings in its petroleum transportation segment (comprised of Trans Mountain, Corridor, and Express) were up $0.2 million, to $17.4 million in Q3 2006, as higher throughput on the Trans Mountain system offset lower tolls.

The last public debt issue of Trans Mountain was redeemed in November, 2005, and the company no longer has a filing obligation with Canadian securities regulators. At present, we believe that Trans Mountain's financing is via loans from Terasen Inc., and bank debt.

We think that the Trans Mountain system's expansion potential was central to KMI's acquisition of Terasen Inc. In filings on the proposed buyout transaction, the buyout investors indicate that they intend to sell Trans Mountain to Kinder Morgan Energy Partners, LP (KMP). KMP is the main operator and financier for KMI's other liquids transportation pipeline assets, as well as its natural gas, carbon dioxide and refined products terminals businesses. Recently, Trans Mountain has received approval from the National Energy Board (NEB) to expand system capacity with the Anchor Loop project, through the sensitive Jasper and Mount Robson parks. A pump station addition, expected to be in service in April 2007, will increase capacity from Alberta to the area near Vancouver and the border with the State of Washington from 225,000 bpd to 260,000 bpd. The looping expansion, although it sounds modest with an additional 7.6 kilometers of 30 inch pipe, and 151 kilometres of 36 inch pipe, will further increase capacity to 300,000 bpd. The loop is expected to be in service in 2009. This first phase expansion of Trans Mountain is expected to cost $660 million. A proposed second phase, TMX-2, could add 100,000 bpd of capacity by 2011.

Trans Mountain's proposed 2006 to 2010 incentive toll settlement, as filed in October, with the support of the Canadian Association of Petroleum Producers, was approved by the NEB on November 24th. KMI said that the settlement "provides commercial support for the first phase of the Trans Mountain expansion". On November 23rd, the

NEB approved a 2007 Multi-Pipeline ROE of 8.46%, down from 8.88% in 2006. The downward adjustment is driven by the November 2006 Consensus Forecast for a 10-year Canada bond yield of 4.15%, and the observed differential between 10 and 30 year Canadas in October of 7 bps. We think the lower ROE is mildly negative for credit quality, though the financial impact should be too small to drive any rating changes, or move spreads for companies in the sector with NEB-regulated assets. We now expect similarly stingy ROEs for all Canadian regulated utilities with automatic rate adjustment formulae.

Corridor Pipeline

**Terasen Pipelines (Corridor) Inc. (A/ n.r./ A2)** is not a reporting issuer with Canadian securities regulators, and Terasen Inc. does not break out results for Corridor. Variation in transportation volumes on Corridor does not affect earnings, as all of its capacity is contracted through ship-or-pay arrangements. Corridor has considerable expansion potential, including building a 42 inch diluent/ bitumen pipeline, another 20 inch refined products pipeline, and expanding tankage and pumping capacity from the Muskeg River mine north of Fort McMurray to Edmonton. The proposed $1.6 billion in expansions would increase capacity from 278,000 bpd (after the expansions completed in April of 2006, which increased capacity by 20,000 bpd from 258,000 bpd) to 460,000 by 2009. Shippers received definitive approval for expansion of the Muskeg River mine in November, 2006, and construction of the Corridor expansion could begin anytime.

Express/ Platte pipeline system

We think that any sale of Terasen Inc.'s 33% equity stake in the Express system could be complicated, as Terasen's partners, OMERS and Teachers', would presumably have to approve the transaction. Nonetheless, at a reasonable price, we think it is easy to imagine willing bidders who would also be capable operators, which could assuage the concerns of OMERS and Teachers'.

Proposed Divestitures

In addition to the buyout investors' apparently firm plans to "drop-down" the Trans Mountain system to KMP, the group has indicated that it will consider a variety of possible transactions, including the spin-off, sale, joint venture, or public offering of all or part of various assets, including Terasen Gas, 75% of Corridor, and its share of the Express/ Platte system. The intent is to reduce post-transaction leverage with the proceeds of such sales, and certain of the buyout credit facilities will allow prepayment without premium or penalty. The buyout investors have disclosed that they "have had discussions with rating agencies and potential lenders about a number of these potential transactions as alternatives to reduce the leverage at KMI following the merger, including … an initial public offering of Natural Gas Pipeline Company of America and Terasen Gas", which seems to us like a fairly advanced stage of consideration of a transaction to sell Terasen Gas. While the buyout investors say they have not yet definitively decided to pursue any of these transaction, they "believe it is likely that KMI will undertake one or more of such transactions at some point following the merger."

Terasen Inc.'s two MTNs have covenants that include an issuance test that limits funded debt leverage to 75% of capitalization. However, this is not a maintenance covenant, and we think it is therefore conceivable that, after some of these asset sales, and after a return of capital from Terasen Inc. to KMI, that Terasen Inc.'s leverage could rise above 75%. The two MTNs also restrict merger and amalgamation to a successor company incorporated in Canada. The acquirer of Terasen Inc. was Kinder Morgan Finance Company, an Alberta-registered ULC. Unlike the case of certain Bell Canada bonds, which would have been redeemed had Bell's proposed trust conversion proceeded, there are no covenants in the Terasen bonds that require consent for mergers, or for the sale of assets. Terasen Inc.'s capital securities due 2040 have no leverage covenant, and allow merger or consolidation with successor companies incorporated either in Canada or the U.S.

So far in 2006, Terasen Inc.'s consolidated debt has remained roughly flat to year-end 2005, at about $3.0 billion. Of this, $450 million is at Terasen Inc. ($200 million MTNs due December 2008, $125 million MTNs due April 2014, and $125 million of capital securities due 2040, callable before April 2010.) Terasen Gas has $1.4 billion outstanding. $300 million is outstanding at Corridor, and about US$510 million (including US$250 million of subordinated debt) is outstanding at Express.

KMI bonds to share security

The definitive proxy statement filed by KMI on November 15th indicates that the approximately $8.6 billion of senior secured credit facilities, and certain outstanding notes of KMI and its Canadian subsidiary Kinder Morgan Finance Company ULC, will be guaranteed by KMI's "wholly-owned material domestic restricted subsidiaries", and secured by the shares and assets of KMI's "direct wholly-owned restricted subsidiaries (limited, in the case of foreign subsidiaries, to 65% of the capital stock of such subsidiaries)." The proxy statement cautions that "The documentation governing the senior secured credit facilities has not been finalized", and that final terms may differ from the proxy's description.

The Terasen Inc. MTNs were issued with a negative pledge covenant, that we believe would preclude Terasen's assets from being pledged unless Terasen Inc. bonds shared in the security with equal ranking. Hence, we do not think that Terasen Inc. bondholders are likely to be harmed by this granting of guarantees and security to the senior secured credit facility lenders and KMI's bondholders. Based purely on the description in the proxy statement, the status of Terasen Inc. bondholders is not crystal clear to us. However, in a Moody's press release of November 14th, Moody's stated that the Terasen Inc. bonds "will not be secured". This is logical, due to the negative pledge, and the fact that Terasen Inc. is not a domestic subsidiary of KMI. Moody's added that Terasen Inc.'s senior unsecured bond rating post-completion of the transaction would likely be Ba2, the same as the anticipated KMI rating, reflecting Terasen Inc.'s "proximity to highly-rated operating subsidiaries", and its structural subordination to these subsidiaries.

Incentives

Even if KMI is willing to sell Terasen Gas, Express, and 75% of Corridor, it seems clear that it wishes to keep Trans Mountain. The proxy statement discloses that a portion of Tranche D of the credit facility (a $2 billion three-year term loan) is to be made available to "a Canadian subsidiary of the borrower in Canadian dollars." No further detail is given, though we speculate that such funding could be used to fund part of the Trans Mountain and/or Corridor expansions. We think that, as KMI will continue to own and operate the NEB-regulated Trans Mountain system, and presumably be at least a 25% owner of Corridor, it will likely seek Canadian capital market funding for these operations at some future date. As a result, we think KMI has strong incentives to maintain and improve its standing in the Canadian bond market, making it highly likely in our view that KMI will treat Terasen Inc. bondholders as well as it treats its own.

We think it is possible that, once final documentation makes it very clear that Terasen Inc. bonds are carved out of the senior secured credit facility security package, and the buyout group's plans for the Terasen group also become clear, Terasen Inc. bonds may once again be viewed as good value. Until then, the imminent downgrades to below investment grade, and the uncertainty over asset sales, make the outlook too cloudy for us to give an unqualified recommendation on Terasen Inc.'s outstanding debt, despite the 2014 MTNs' approximately 105 to 120 bp premium over its closest pipeline company peers.

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**Terasen Gas Inc. (**senior unsecured **A/ BBBpi/ A3)** has been one of the better-performing corporate credits over the past 10 months, following the spread widening that took place upon Kinder Morgan Inc.'s announcement of the Richard Kinder-led group's going-private proposal in late May 2006. Even though Terasen Gas long bonds have tightened from over 140 bps to under 115bps since then, we still think Terasen Gas long bonds offer very good value within the natural gas distribution utility sector. Its natural peers, Union Gas and Enbridge Gas Distribution, are marked at about 105 bps and 98 bps, respectively, in the long end. We think that the **Fortis Inc. (BBB(high)/ BBB/ n.r.)** acquisition of **Terasen Inc. (BBB(high)/ BB-pi/ Baa2)**, comprising primarily Terasen Gas Inc., Terasen Gas (Vancouver Island) Inc., and Terasen Gas Squamish Inc., will continue to benefit both Terasen Gas bonds and Terasen Inc. bonds, after the deal closes, which is expected to occur this quarter. We think that within about a year's time, Terasen Gas should trade roughly in line with Union Gas and EGD.

Closing Conditions

KMI's February 26th agreement to sell Terasen Inc.'s gas distribution businesses to Fortis was subject to closing conditions. Essentially, the key conditions are regulatory approval, and removal of all of the Kinder Morgan Canada (the Terasen division formerly known as Terasen Pipelines) liquids transportation assets. These assets are mainly the Trans Mountain Pipeline, the Corridor Pipeline, and Terasen's one-third interest in the Express/Platte system.

On March 5th, KMI entered into an agreement to sell Corridor to Inter Pipeline Fund for $760 million. Inter Pipeline has said that this transaction should close in mid- May. On April 30th, KMI sold the Trans Mountain system to Kinder Morgan Energy Partners, for US$550 million. Also on April 30th, the British Columbia Utilities Commission approved KMI's sale of Terasen Inc. to Fortis. In its definitive proxy filing related to the going-private transaction, KMI said that its interest in the Express/Platte system might also be sold. We now believe that KMI intends to keep Express for the time being, but it must be removed from Terasen Inc. prior to closing the Terasen sale to Fortis. Fortis and KMI have both said they expect the Terasen sale to close in the second quarter.

Regulatory

The BCUC's approval for Fortis to purchase the Terasen gas distribution utilities was also subject to certain conditions. The most significant for bondholders was the BCUC's stipulation that the ring-fencing imposed as a condition of KMI's acquisition in 2005 be maintained. (Fortis did not request any changes to the ring-fencing in its application.) The BCUC also ordered that a majority of Directors of the regulated entities continue to be independent, as a further reassurance that the ring-fencing will be adhered to. Finally, the BCUC ordered that the geographic location of existing functions be maintained, and that all data and servers used in providing service be located in Canada, unless otherwise approved by the BCUC. There was no public opposition to Fortis' purchase of Terasen, in contrast to the significant public opposition to U.S.-based KMI's purchase in 2005. We expect that, at some future date, Fortis may request that the ring-fencing be loosened, as it is unusual- unique, we believe- in the Canadian regulated utility space. However, we think that the BCUC would not automatically respond favourably to a request to relax these conditions, and it may seek some other assurance that the financial integrity of the utilities would be maintained. We think this expected durability of the ring-fencing results in a regulated utility that is especially favourable for bondholders.

The allowed ROE for Terasen Gas in 2007 will be 8.37%, a sharp drop from the 8.80% in 2006, though driven by the same formula, with an annual reset based on forecast Canada bond yields. The TGVI ROE is 70 bps higher than the Terasen Gas ROE. Apart from the low ROEs (which are prevalent across the country), we think that regulation in BC has lately been reasonably benign for bondholders. We think this is in contrast to the regulatory situation in Ontario.

We have for some years now thought that regulation in Ontario has been fair and benign for bondholders. More recently, however, we sense a shifting tone from the Ontario Energy Board, the regulator of both natural gas distribution and electricity distribution. Last summer, the OEB's technical conference on electricity distributors' allowed ROEs saw OEB staff take up suggestions from academic experts that prevailing ROEs were significantly higher than necessary, and the ROE-setting methodology should change to a method that would yield much lower ROEs. We found this especially upsetting, since the electricity distributors in particular are facing very significant capital spending pressure from an aggressive timetable for the government-mandated smart meter rollout. In the end, the OEB did not change its methodology, but we are concerned that the OEB will revisit the ROE issue at a later date, engaging the same academic experts. In February, the OEB revisited the Union Gas base pressure gas sale from 2003, and appeared to us to move away from the spirit of last year's ATCO decision by the Supreme Court of Canada. The Supreme Court ruling was in favour of utility shareholders (and by extension, enhanced bondholder protection), and we thought it was clear and unequivocal. Taken together, we think these two actions may signal that the OEB is in the process of becoming less friendly to companies, perhaps in order to limit rate pressure, in response to the ongoing rise in the unregulated commodity costs for both gas and electricity. For the moment, we have to think that the regulatory climate in BC is a little more benign for bondholders.

Operations and Capital Spending

Simply put, we see no material operational issues at Terasen Gas of concern to bondholders. Performance Based Regulation rate agreements appear to be working as intended, reducing rate pressure for consumers, and at the same time giving the utilities a chance to earn, and even marginally exceed, the allowed ROE, if cost savings are achieved, and if quality of service standards are maintained. We understand that ongoing maintenance and new connection capex for Terasen Gas is in the neighbourhood of $75 million per year. Terasen Gas cash from operations has been in the range of about $150 million.

Terasen Gas Summary

We think that the shifting regulatory climate in Ontario, combined with the BCUC ring-fencing, the lack of any material operational or capital spending "issues" and the solid track record of operations at Terasen Gas, and Fortis' track record of running its regulated utilities smoothly, all support our view that Terasen Gas should eventually trade more or less flat to Union Gas and EGD, perhaps within a year or so.

Terasen Inc.

As we mentioned above, Terasen Gas cash from operations of about $150 million, and maintenance capex requirements of about $75 million, leaves some free cash flow for a dividend to support the Terasen Inc. bonds. We calculate that a $70 million dividend is just about adequate to service and retire Terasen Inc.'s $450 million of outstanding debt in late 2014, when the last of the three currently outstanding issues matures. A slightly lower dividend would take slightly longer to retire all $450 million in Terasen Inc. debt. Terasen Inc. would require some interim financing to meet maturities (the $200 million of MTNs in December 2008, the $125 million Capital Securities that are callable in April 2010, and the $125 million MTNs due in September 2014). However, we believe that this could be easily and economically accomplished with bank lines, such as an extension of Terasen Inc.'s current $450 million three-year revolving line, which is due May, 2009. We don't suggest that this is, or should be, Fortis' plan for dealing with the Terasen Inc. debt. We expect that the Terasen Inc. bonds will be viewed as roughly equivalent to a Fortis Inc. credit upon closing of the acquisition, given notional "stand-by" parental support of Terasen Inc. by well-diversified Fortis, and considering the bonds' position between Fortis and the attractive Terasen Gas utility assets. Our calculation simply points out that actual cash infusions from Fortis may not be required to service the Terasen Inc. bonds. We think Terasen Gas has adequate financial flexibility to fund incremental capital spending (above maintenance levels) within the confines of the ring-fencing requirements. Year-end 2006 leverage at Terasen Gas (adjusted for gas in storage) was 60.8%, lower than the BCUC deemed debt leverage of 65%. Hence, we think there is room for some spread narrowing of, for example, the Terasen 2014s, now marked at about 100 bps.

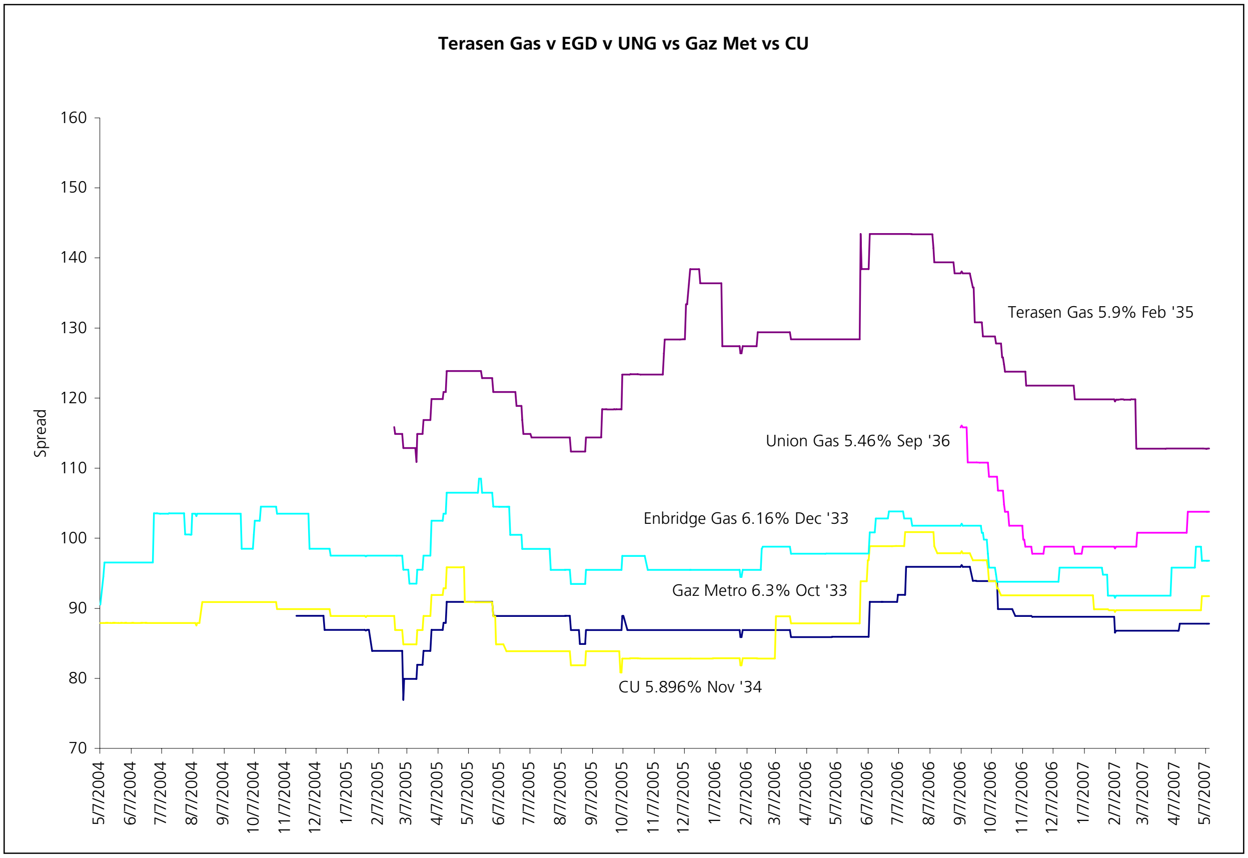
LNG Storage Facility on Vancouver Island

From the mid 1990s to 2005, BC Hydro considered several options for meeting electricity demand growth on Vancouver Island. The preferred solution was to be a 252 MW natural-gas fired co-generation plant at Duke Point near Nanaimo. The Duke Point plant would have required about 45 TJ/day of firm gas transportation capacity. Terasen Gas (Vancouver Island) was, at the same time, considering system capacity upgrades. In 2004, TGVI made a Resource Plan Filing and concurrent application for a Certificate of Public Convenience and Necessity with the regulator that proposed an LNG storage facility as the key element of system upgrades that would meet organic growth for natural gas, as well as the jump in demand that Duke Point would represent.

The BCUC Panel that considered the TGVI application concluded that the Mount Hayes site proposed for the LNG storage facility was well-suited to the project, and that construction and operation of the LNG facility would not result in significant health, safety or other impacts to the public. The Panel also concluded that the LNG option would present several material benefits to ratepayers, including lower costs, compared to the other available options, such as compression, looping, and curtailment during peak load periods. These conclusions, however, were made on the basis of assumptions that included the construction of Duke Point. The BCUC's February, 2005 approval of TGVI's proposal was conditional on, among other things, obtaining a firm service contract to supply Duke Point.

Later in 2005, BC Hydro abandoned the Duke Point project. Growing electricity demand on Vancouver Island will instead be met by the Vancouver Island Transmission Reinforcement Project, which will replace an existing pair of 138 kV transmission lines from the Mainland to Vancouver Island with a pair of 230 kV lines, running in the same right of way. This project was approved by the BCUC in July, 2006, and is expected to be in service in late 2008. The Mainland supplies about 70% of Vancouver Island's electricity, with the remainder coming from hydraulic, gas-fired, and other small-scale generation on the Island.

As a result of BC Hydro's abandonment of Duke Point, the 2005 approval for TGVI's proposed LNG facility has lapsed. However, organic demand for natural gas delivery on Vancouver Island continues. Additionally, there are other proposals for gas-fired generation projects to help meet electricity demand, even though these are much smaller in scale than Duke Point. As a result, we expect that TGVI will have to revisit its plan for an LNG storage facility, perhaps in a scaled-down form. The project would store LNG in off-peak periods, and vaporize the LNG to supply the system with natural gas during peaks. While we believe that timing for such a project is not yet well-defined, we suspect that demand will soon reach levels where enhancements to the Island system are inevitable. We also think it likely that the rationale for the BCUC's approval of the LNG storage proposal will be little changed by the somewhat reduced supply requirement for gas-fired electricity generation. Hence, we anticipate that TGVI may need to build such a facility in the medium term. Assuming a relatively straightforward application and approval, we would not consider such a project as being negative for Terasen Gas credit quality, though it could imply incremental debt issuance, perhaps within a few years. The 2004 proposal for a 1.0 Bcf facility had an estimated cost (in 2004 dollars) of roughly $100 million. We would expect that recent materials and labour cost increases in Western Canada may have an impact on any new cost estimate.


Terasen Gas v EGD v UNG vs Gaz Met vs CU
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Terasen Gas 5.9% Feb '35
Union Gas 5.46% Sep '36
Enbridge Gas 6.16% Dec '33
Gaz Metro 6.3% Oct '33
CU 5.896% Nov '34
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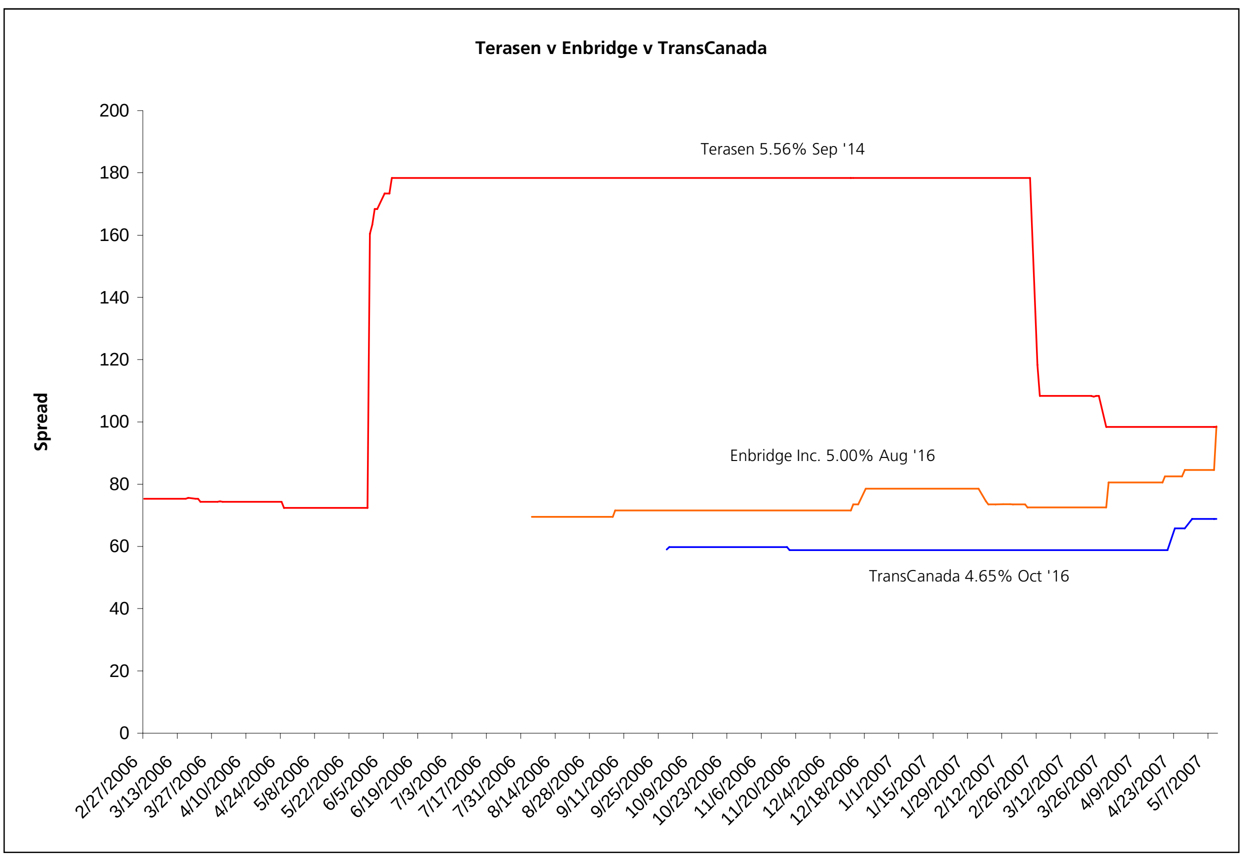
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200
180
160
140
120
100
80
60
40
20
0
Terasen 5.56% Sep '14
Enbridge Inc. 5.00% Aug '16
TransCanada 4.65% Oct '16
2/27/2006
3/13/2006
3/27/2006
4/10/2006
4/24/2006
5/8/2006
5/22/2006
6/5/2006
6/19/2006
7/3/2006
7/17/2006
7/31/2006
8/14/2006
8/28/2006
9/11/2006
9/25/2006
10/9/2006
10/23/2006
11/6/2006
11/20/2006
12/4/2006
12/18/2006
1/1/2007
1/15/2007
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2/26/2007
3/12/2007
3/26/2007
4/9/2007
4/23/2007
5/7/2007

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**FortisBC Energy Inc. (**FEI, senior unsecured **A/ n.r./ A3),** until recently known as Terasen Gas Inc., has been seeking to offer a variety of innovative alternative energy services. On one hand, we view this as a natural response to the prevailing sentiment to improve societal energy efficiency, and reduce so-called "greenhouse gas" emissions. At least as important, we also view these services as FEI's apt response to the B.C. provincial government's Energy Plan of 2007, and the *Clean Energy Act* of 2010. However, these recent initiatives in alternative energy services have met with resistance from providers of competitive services, and seem to have the regulator questioning the role of the Fortis natural gas utilities in providing these services. These services could help stimulate demand by enabling switching to natural gas from fuels with higher carbon content, which would enable attainment of public policy goals, while making the Fortis distribution network more efficient. We think both these ends are consistent with maintaining FEI's credit quality, and we will follow the regulatory proceedings with interest. Meanwhile, the "plain vanilla" natural gas distribution business has exhibited better credit ratios, in part due to the December 2009 cost of capital review, which awarded more equity thickness and a higher ROE. LTM FFO interest coverage has been steady at 2.7x since Q1 of 2010, a material rise from the typical 2.3x coverage for much of the previous decade. With very modest new issuance requirements for the next few years, we think FEI bonds will remain steady performers, compared to the non-utility sector, and even compared to most of its utility sector peers. We see the FEI bonds as fairly valued compared to most gas distribution peers, and better value than, for instance, Gaz Métro, given what in our view is better credit quality and better ratings stability

New Name, New CEO

In July, 2010, Mr. John Walker, President and CEO of FortisBC Inc., also became President and CEO of Terasen Inc. and Terasen Gas Inc. This represented a strategic initiative to bring Fortis Inc.'s B.C. natural gas and electricity utilities under common leadership.

Subsequently, Terasen Inc. changed its name to FortisBC Holdings Inc., and Terasen Gas Inc. was re-named FortisBC Energy Inc. The other operating companies for Vancouver Island, Whistler, and Fort Nelson also changed their names to brand them as members of the Fortis group. Fortis believes that this will ensure "consistent focus and strategy", and allow the group to "combine strengths and resources to create new opportunities to better serve our customers and provide integrated energy solutions for communities."

New Initiatives

A key recent FEI initiative was the Customer Care Enhancement Project. The project comprises implementation of new customer information service software, the establishment of two call centres, and moving in-house the billing and back-office functions that had been contracted out (initially in a joint venture with Enbridge Gas) around 10 years ago. This significant project resulted in the creation of some 300 jobs, and had an estimated total cost of $115 million. The British Columbia Utilities Commission approved the project because evidence showed it would result in some customer benefits and "potentially significant but to some degree un-quantified socio-economic benefits to B.C."

The province of B.C. has been keenly interested in energy efficiency and conservation, as well as $CO_2$ ("greenhouse gas") emissions reductions. The *Utilities Commission Act* requires that the government's energy objectives, particularly the *Clean Energy Act* of 2010, be considered in BCUC approval of utility expenditures. In particular, this includes support of energy conservation or efficiency, or the use of clean or renewable energy sources, as well as reduction of greenhouse gas emissions. FEI's response was its Energy Efficiency and Conservation program, which was approved by the BCUC in 2009. The program includes residential and commercial energy efficiency programs, conservation and outreach programs, and other measures such as fuel switching to natural gas from fuels with higher carbon content. FEI projected savings of almost 10 million gigajoules over the lives of these various measures, offset to some degree by higher natural gas consumption due to fuel switching.

While in a narrow operational sense, we don't view such energy efficiency or alternative energy programs as beneficial for a utility's credit quality, we acknowledge that from a public policy perspective, they are a desirable, and perhaps even a necessary response to government policies, such as B.C.'s *Clean Energy Act* and regulations. Hence, in very broad sense, we do see such programs as consistent with maintaining credit quality, by growing the business while conforming with important government policy initiatives. We note that the Energy Efficiency and Conservation program's expected costs of roughly $40 million have been blessed by the regulator, and are thus highly likely to be recovered in rates, though they will be captured in a deferral account and amortized over periods of up to 10 years.

A biogas option has recently been made available. For an approximately $4 per month premium, customers can opt to replace 10% of their natural gas supply with biomethane, gathered from agricultural waste through on-farm anaerobic digesters, and from the existing Salmon Arm landfill. The program could allow estimated greenhouse gas savings of about 11,000 tonnes. However, the BCUC approved this service as a test program only, conditional on it being "distinct and severable" from the utility business, and "made no finding on the acceptability of the biogas upgrading business" for FEI.

A proposed Natural Gas Vehicle program would have seen FEI own and operate refuelling stations for fleet vehicles on customer's premises. One contract between FEI and Waste Management of Canada for a compressed natural gas fuelling station to service a 20 vehicle fleet was given conditional, interim approval. However, the BCUC expressed concerns vis-à-vis the *Clean Energy Act* and the appropriate role of a utility in stimulating demand for NGVs, as well as the potential risk of cost under-recovery of this service falling on utility ratepayers. The BCUC didn't approve FEI's request for a broader NGV program at this time.

FEI has also proposed expanding its service offerings to include Alternative Energy Solutions, now renamed Thermal Energy Services. These proposed offerings include Geo-exchange, Solar-thermal, and District Energy Systems. In response to a complaint by the Energy Services Association of Canada, and potential concerns expressed by other interveners, the BCUC will conduct an inquiry to review FEI's proposals in alternative energy services later this year. The BCUC has encouraged participants in the review to take a broad perspective, to assess (among other things) the appropriate role of traditional gas utilities in the market for alternative energy services. FEI is expected to file evidence by August 29th, which will be followed by interveners filing evidence by October 19th, followed by a procedural conference in mid-December. We expect a lengthy process for this inquiry, with a decision clarifying FEI's role in alternative energy services sometime in 2012.

Rate Application

FEI's current rates are based on a negotiated settlement agreement with customer groups for 2010 and 2011. The all-in customer rate, including changes in commodity costs, increased 10% in 2010, in part reflecting the December 2009 cost of capital decision, which lifted deemed equity capitalization to 40% from 35%, and increase the allowed ROE to 9.50% from 8.47%. (The new equity capitalization and ROE will remain in place until further review by the BCUC.) The all-in rate declined by about 6% in 2011, due to decreased commodity and midstream costs.

In May, FEI filed an application for 2012 and 2013 rates with the BCUC. The filing seeks a 5.0% increase for the typical residential customer for 2012, and a further 6.4% increase for 2013 (excluding changes in the commodity cost). An oral hearing will commence on October 3rd, and the current regulatory schedule anticipates FEI filing its final reply argument submissions on January 18th, 2012. We expect the BCUC decision on rates to be released late in Q1, or early in Q2 of 2012.

Capital Spending

FEI's 2012-2013 rate application projects capital spending of $146 million in 2011, $148 million in 2012, and $131 million in 2013. This run-rate is consistent with the recent trend, with capex of $130 million in 2009, and $137 million in 2010. Major projects include the replacement of two pipelines running under the Fraser River. These upgrades enhance pipeline seismic stability, addressing river erosion concerns, and thus improve safety and reliability. The customer care enhancement project has also been a key focus of capex. Two new B.C.-based customer contact centres, one in Burnaby, and one in Prince George, are being complemented with new customer information and billing systems. This previously approved "in-sourcing" initiative is expected to result in operating cost savings, beginning in 2012.

The construction of the Mt. Hayes liquefied natural gas storage facility on Vancouver Island was substantially complete as of May 31st. **FortisBC Energy (Vancouver Island) Inc. (n.r./ n.r./ A3)** is now filling the tank for the upcoming winter heating season. The Mt. Hayes project helped lift FEVI capex from a run-rate of roughly $18 to $25 million between 2006 and 2010, to a projected $67 million in 2011, $36 million in 2012, and $29 million in 2013. The much smaller Whistler and Fort Nelson operating companies have capex of $1 million per year for this period, except for a special project in Fort Nelson that is expected to raise its capex to $3 million in 2011.

We believe that these modest capex amounts will lead to equally modest net new issuance for the next couple of years. Due to the consequent growth in rate base, we expect nominal total debt may rise, in order to maintain the debt to capitalization ratio consistent with the regulatory deemed 60%.

Amalgamation Proposal

Terasen Inc. acquired the Vancouver Island gas distribution business from Westcoast Energy in 2002. From inception, this business had a relatively high cost structure and small customer base. Agreements between the utilities and the Federal and Provincial governments helped the Vancouver Island distribution business establish and maintain a rate structure competitive with other energy sources. These special arrangements, which included payments from the province to offset the commodity cost to natural gas customers, and a revenue deficiency deferral account, will expire at the end of 2011. Despite these special arrangements, Vancouver Island residential customer rates are approximately 60% greater compared to a Lower Mainland customer. To help prevent a further rate increase for Vancouver Island customers that FEI estimates at about 20% by 2016, FEI is proposing an amalgamation of all its B.C. operations, with a harmonized or "postage stamp" rate structure. The proposed amalgamation would be effective on January 1st, 2013. The FortisBC Whistler and FortisBC Fort Nelson operating companies would also be amalgamated, to create one natural gas distribution entity.

Since the amalgamation would blend the cost of service on Vancouver Island and the Mainland service territory of FEI, it would raise rates for a typical Lower Mainland residential customer by about 4% of the annual bill. For this reason, we expect that the application might be opposed by some consumer groups.

Evidence on FEI's proposed capital structure for the amalgamated entity will be given in the amalgamation filing, which is expected this fall. At present, all the FortisBC Energy companies have 40% equity capitalizations. FEI has a 9.50% allowed ROE, while the other operating companies have 10.00% ROEs, reflecting their higher operating risk characteristics. Should the amalgamation be approved, we think it would likely be neutral for FEI credit quality, especially if the amalgamated entity were awarded a slightly higher equity capitalization, or a blended ROE, to recognize the higher operating risk of the smaller operating entities embedded within the amalgamated whole.

Ratios and Ratings

As a result of the BCUC's December 2009 cost of capital decision, deemed common equity was raised to 40%, from 35%. FEI issued shares to Fortis Inc. in Q1 of 2010, to raise the equity thickness. This brought actual debt to capitalization down to 58.5%, from 65.2% at year-end 2009. We estimate debt to cap at 59.3% as of the end of Q1 2011 (58.3%, adjusted for gas in storage).

FEI's LTM FFO interest coverage was 2.7x at the end of Q1 this year, consistent with full-year 2010. This is improved from the 2.3x to 2.5x level typical of the previous five years, due largely to the cost of capital decision's higher deemed equity and higher ROE. LTM FFO/debt was 11.9% as of the end of Q1, improved from levels that were at times below 10% prior to the cost of capital decision. We expect these ratios to remain stable going forward.

We expect the trend on the DBRS ratings, and the outlook on the Moody's ratings, to remain stable for the foreseeable future. While we would expect both rating agencies to study the proposed amalgamation very carefully, we don't expect the proposed amalgamation, if approved, would affect ratings or outlooks, especially if the higher operating risk of the smaller entities is reflected in the amalgamated utility's cost of capital.

**FortisBC Holdings Inc. (BBB(high)/ n.r./ Baa2**) (formerly Terasen Inc.)

The Terasen Inc. public debt issues that have matured since the Fortis acquisition have not been replaced with new issues by Terasen Inc., which has ceased issuing public debt. Only one legacy Terasen Inc. issue remains outstanding, the 5.56% MTN due September 2014. This is a small issue, and very illiquid, but if it can be found near where we have it marked, at roughly 77 bps over the curve, we consider it very good value. The Terasen Inc. bonds have traded very cheap compared to the ring-fenced FEI (former Terasen Gas) bonds, although we always thought the Terasen Inc. credit had been oversold. Perhaps a bit of a hangover, from the days of the Kinder Morgan ownership and non-investment grade rating, remains built into the market's perception of this bond.

Despite their "Holdco" status, we like the Terasen Inc. / FortisBC Holdings Inc. bonds. The assets owned by FortisBC Holdings, namely the whole Terasen group of natural gas distribution companies, have proven to be quite valuable, and we think Fortis Inc. would not let its interest in FortisBC Energy be jeopardized by any interruption in the credit quality of FortisBC Holdings.

Most recently, FortisBC Holdings has issued two notes to Fortis Inc. A $200 million, 5.00% unsecured 10-year note was issued in December, 2010. On March of this year, FortisBC Holdings borrowed $300 million from Fortis Inc., and the proceeds were used to purchase Series F 5.25% preferred shares of FortisWest, which owns FortisBC Inc. via its ownership of Fortis Pacific Holdings. We view such capital management transactions as neutral for the credit quality of FortisBC Holdings.

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COMPANY UPDATE | COMMENT

MAY 4, 2010

# Fortis Inc.

## Q1/10: Recent regulatory decisions give modest boost

### Sector Perform

### Investment Thesis and Highlights

Fortis Inc. released Q1/10 financials on April 30, 2010. On May 3, 2010, financial statements for Fortis subsidiaries FortisAlberta, FortisBC, Newfoundland Power and Terasen Gas were made available on Sedar.

### Investment Thesis and Highlights

**Slight positive from recent regulatory decisions:** Net debt/capital and $FFO_{LTM}$/debt on a consolidated basis improved modestly in Q1/10, compared to Q4/09, mainly due to the issuance of preferred shares in January 2010, with funds used to boost equity at Terasen Gas and reduce short-term debt. Consolidated interest coverage ratios in Q1/10 are roughly in line with a year ago (Exhibit 2), EBITDA/interest of 3.0x and EBIT/interest of 2.0x.

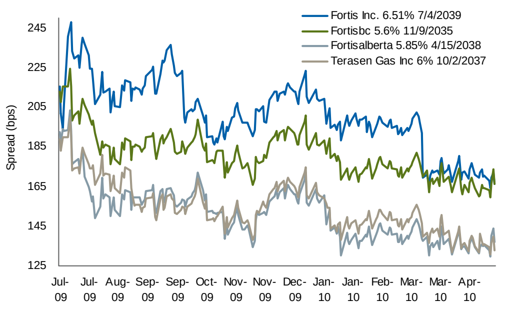
**Cash flow up slightly:** Consolidated FFO of $204 million in Q1/10 was slightly ahead of the $200 million generated in Q1/09 (Exhibit 2). Consolidated EBITDA increased 6.6% to $322 million in Q1/10 compared to $302 million in Q1/09. Key factors contributing to the increase were increased earnings at regulated subsidiaries as a result of recent regulatory decisions (i.e., increased ROEs and deemed equity levels) and rate base growth, partially offset by lower earnings from non-regulated generation operations.

**Manageable FCF deficit:** Fortis generated a gross FCF deficit of $88 million in Q1/10, which is above the FCF deficit of $70 million in Q1/09 (Exhibit 2). The timing of paying out two quarters of cash dividends in Q1/10 is the key factor for the higher deficit during this recent quarter.

**Fortis Inc. bonds offer decent yield pick-up over opco bonds:** We think the current discount that Fortis Inc. “holdco” bonds trade at compared to bonds issued by its regulated utility opco’s provides investors with a decent yield pick-up (Exhibit 1) to compensate for the associated structural subordination, especially when considering the diversified and stable source of cash flow generated by its group of utility subsidiaries. We highlight that the key risk in holding Fortis Inc. holdco bonds is the potential risk of a sizable acquisition that would result in the issuance of a material amount of holdco debt. However, based on past transactions by Fortis Inc., we would expect such a transaction would involve sufficient equity funding to maintain existing credit ratings. Of the group of Fortis subsidiaries, we think FortisBC bonds (Outperform) offer the best value based on a lower valuation relative to most of the regulated utility peer group and the company’s relatively stable financial profile.

**Equity from Fortis to support utility growth:** Certain of Fortis’ utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis over the next few years in order to maintain regulated capital structures as the utilities grow their rate bases. Fortis raises funds through a combination of debt, common equity and preferred equity, such that consolidated leverage remains near 60%. Fortis’ latest issuance was $250 million in cumulative redeemable preference shares on January 11, 2010, of which $125 million was used to inject equity into TGI for its recent 5% increase in regulated equity to 40%, with the remainder used to reduce credit facility balances.

**Fortis Historical Spreads**




Source: ADI

**Fortis Inc. Credit Summary** ($million)

| Cash Flow Summary | 2008 | 2009 | *2010E* | *2011E* |
|---|---|---|---|---|
| EBITDA | 1,048 | 1,065 | *1,118* | *1,174* |
| **FFO** | **635** | **690** | *650* | *680* |
| Capital expenditures | (904) | (1,024) | *(1,100)* | *(1,000)* |
| Dividends | (191) | (161) | *(216)* | *(216)* |
| **Gross FCF** | **(460)** | **(495)** | *(666)* | *(536)* |
| Changes in w/c | 41 | (41) | - | - |
| FCF after w/c | (419) | (536) | *(666)* | *(536)* |
| Other investing | 50 | (21) | - | - |
| **FCF before financing** | **(369)** | **(557)** | *(666)* | *(536)* |
| Debt issuance/(repay.) | (147) | 551 | *291* | *336* |
| Common issuance | 308 | 46 | *40* | *200* |
| Preferred issuance | 223 | - | *250* | - |
| Other financing | 6 | (9) | - | - |
| **Net change in cash** | **21** | **31** | *(85)* | - |
| **Capital Structure** | | | | |
| Total debt | 5,534 | 5,915 | *6,206* | *6,542* |
| Non-controlling int. | 145 | 123 | *123* | *123* |
| Preference Shares | 667 | 667 | *912* | *912* |
| Shareholders' equity | 3,046 | 3,193 | *3,323* | *3,614* |
| **Total capital** | **9,392** | **9,898** | *10,564* | *11,191* |
| Cash and equivalents | 66 | 85 | - | - |
| **Credit Ratios** | | | | |
| Total Debt / Capital | 62% | 63% | *63%* | *63%* |
| Net Debt / Capital | 62% | 63% | *63%* | *63%* |
| EBITDA / interest | 2.9x | 2.9x | *3.2x* | *3.2x* |
| EBIT / interest | 1.9x | 1.9x | *2.2x* | *2.1x* |
| Total Debt / EBITDA | 5.3x | 5.6x | *5.5x* | *5.6x* |
| FFO / Total Debt | 11.5% | 11.7% | *10.5%* | *10.4%* |
| **Credit Ratios** | **DBRS** | **S&P** | **Moody's** | |
| Rating | BBB(high) | A- | NR | |
| Outlook | Stable | Stable | | |

Source: RBC Capital Markets, Company reports, Rating Agencies

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**All values in Canadian dollar unless otherwise noted.**

### Highlights, continued:

- **Preferred shares issued:** In January 2010, Fortis Inc. issued $250 million 4.25% cumulative redeemable five-year fixed rate reset first preference shares at $25/share. Funds from the pref. issuance were used mainly to pay down short-term debt and fund an equity injection into Terasen Gas in response to a regulatory decision on capital structure (see Regulatory section below). Terasen Gas used the funds from the equity injection to reduce short-term debt.
- **One upcoming debt maturity in 2010:** The only remaining debt maturity in 2010 at Fortis Inc. and its various subsidiaries is Fortis Inc.'s $100 million 7.40% senior unsecured bonds due 10/25/2010 (Exhibit 3).
- **Capital securities redeemed:** Subsequent to the end of the first quarter, Terasen Inc. redeemed in full for cash its $125 million 8.0% capital securities due 04/19/2040. This redemption was funded under the company's committed credit facility.
- **Adequate liquidity:** At the end of Q1, Fortis Inc. and its subsidiaries had $1.64 billion available on its $2.15 billion in consolidated credit facilities, compared to $1.43 billion available at the end of 2009 (Exhibit 4). This includes roughly $547 million unused under the corporation's $600 million committed credit facility. In addition, the company had $92 million in cash and equivalents. We think this is more than adequate for the company's near term requirements.
- **Dividend increased:** As of March 31, 2010, Fortis Inc. began to pay its previously announced dividend increase of $0.28/share (up from $0.26/share previously, a 7.7% increase). This will translate to a total common dividend payment of approximately $182 million annually in 2010, compared to $178 million in 2009, which we view as manageable.

### Outlook and Funding Expectations:

- **Approximately $5 billion of capital spending over next five years:** On a consolidated basis, Fortis expects capital spending of $5 billion over the next five years, of which about $1.1 billion is expected to be spent in 2010. Approximately 70% of the capital spending is expected to be incurred at Fortis' regulated utilities, mainly FortisAlberta and FortisBC, and 27% is expected to be at Terasen Gas. Roughly 3% is expected to be spent at non-regulated operations.
- **Utility rate base growth:** Fortis expects its combined utility rate base to grow to $9.4 billion in 2013, representing an average compound growth rate of 7%. Terasen Gas, FortisAlberta and FortisBC will be the key growth contributors.
- **Utility acquisitions a continued focus:** Management continues to look to acquire utility (gas and/or electric utilities or integrated including generation) assets with a size of $1 billion to $5 billion in enterprise value, although nothing is imminent. The company has indicated that an acquisition would have to be EPS accretive in the first year. Geographies of focus are in Canada, the US and the Caribbean. We expect any material acquisition would be funded with a mix of debt and sufficient equity (common and preferreds) to maintain current credit ratings, based on how Fortis has handled past transactions.
- **Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities (see organizational structure in Exhibit 5) provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. Cash inflows from its subsidiaries are expected to exceed $190 million annually. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.
- **Subsidiary funding expectations:** Certain of Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis over the next few years in order to maintain regulated capital structures as these utilities grow their rate bases. Also, as noted above, Terasen Gas received an equity injection of $125 million from Fortis Inc. in the first quarter to boost Terasen Gas' deemed equity base in response to a recent regulatory decision. Based on our forecasts for each subsidiary, we expect the following equity contributions from Fortis and subsidiary debt issuance in 2010:

**Subsidiary Funding Expectations for 2010 ($ millions)**

| Subsidiary | Equity Injection Required from Fortis Inc. | Incremental New Debt Required at Subsidiary | Debt Issued to to Refinance Maturities | Drawn on Credit Facilities | Total Debt Issuance Expected* | Total Funding Expected |
|---|---|---|---|---|---|---|
| FortisAlberta | 50 | 155 | 0 | 65 | 225 | 275 |
| FortisBC | 10 | 86 | 0 | 35 | 100 | 110 |
| Newfoundland Power | 0 | 0 | 0 | 25 | 0 | 0 |
| Terasen Gas | 125 | 0 | 0 | 40 | 0 | 125 |

*Debt issuance rounded to nearest increment of $25 million.

For detailed financial forecasts of each subsidiary, refer to report titled "Utilities in Canada: A Credit Outlook" dated March 29, 2010.

Source: Company reports

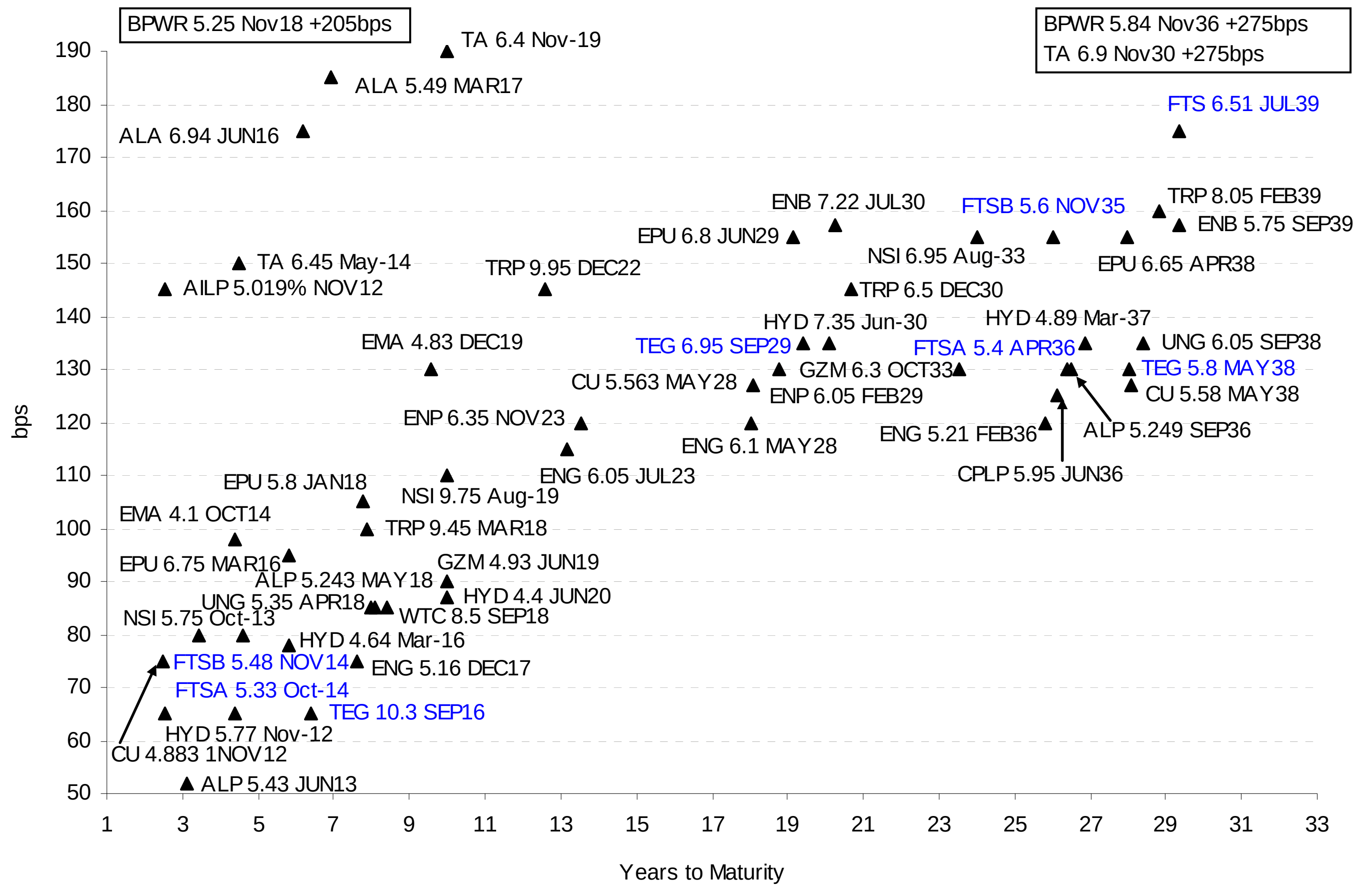
## Regulatory Update:

**Positive regulatory decisions for bondholders:** The following key recent regulatory decisions are supportive for bondholders:

- Alberta: In November 2009, the AUC released Decision 2009-216, providing the second-generation Generic Cost of Capital (GCoC) regulatory framework that was applied retroactively to January 1, 2009. The concept of utility specific deemed capital structures based on risk profile again forms the basis of utility regulation in Alberta. However, the following key changes were made with this recent decision: (i) the equity thickness of all AUC regulated utilities was increased by 100 bps to 400 bps depending on the utility (FortisAlberta's deemed equity was increased to 41% from 37%); (ii) the ROE was set at 9.0% (up from 8.75% in 2009 – or the 8.61% that would have applied in 2009 had the previous automatic adjustment formula been used in 2009); and (iii) the AUC deferred a decision on the design or use of a formula-based automatic adjustment until it has had the opportunity to assess changes in the capital markets and to reconsider the types of factors that should be built into any future formula. On February 26, 2010, the AUC began an initiative to reform utility rate regulation for electricity and natural gas distribution in Alberta (electricity and natural gas transmission has been excluded from this process for now). Stakeholders will be consulted during the process. The intent of the initiative is to move to a performance-based regulatory (PBR) framework in which prevailing rates are adjusted annually by a formula that incorporates inflation and productivity improvements. The target date for implementation of the PBR is July 1, 2012, based on applications filed by the utilities in the first quarter of 2011.
- British Columbia: On December 17, 2009, the BCUC released a decision on regulated utilities in British Columbia, retroactive to July 1, 2009. The decision included: (i) higher ROE's for Terasen Gas and TGVI of 9.5% and 10%, respectively (previously 8.47% and 9.17%), and 9.9% for FortisBC (previously 8.87%); and (ii) increased the deemed equity for Terasen Gas to 40% from 35%. The BCUC also discontinued the use of an automatic adjustment formula for setting ROEs and has directed Terasen Gas to complete a study of alternative formulae and to report to the BCUC by December 31, 2010.
- Ontario: In December 2009, the OEB released its decision on the cost of capital for regulated utilities in Ontario, raising the allowed ROE to 9.75% (550 bps risk premium over a 4.25% forecast of the Canada bond yield) effective 2010 (from 8.01% in 2009). In addition, the OEB modified its ROE adjustment formula to include the influence of utility bond spreads. Going forward, the allowed ROE formula will incorporate the change in the spread on the utility bond index as well as the change in government bond yields, each weighted at 50%. Previously, the formula only factored in changes in the government yield. This ROE will apply to electricity distributors and transmission providers, and natural gas distribution utilities.

For more details on regulatory changes in Canada see our report titled "Canadian Utilities: A Credit Outlook," published on March 29, 2010.

**Exhibit 1: Relative Value Chart - Canadian Utilities and Pipelines**




Source: ADI, RBC Capital Markets Research

### Exhibit 2: Fortis Inc. Historical Financials and Forecasts

| **Fortis Inc** ($million) | **Annual** | | | | **Quarterly** | | | | **Forecasts** | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Earnings Summary** | **2008** | **2009** | **31-Mar-09** | **30-Jun-09** | **30-Sep-09** | **31-Dec-09** | **31-Mar-10** | **LTM** | *2010E* | *2011E* |
| EBITDA | 1,048 | 1,065 | 302 | 248 | 229 | 286 | 322 | 1,085 | *1,118* | *1,174* |
| EBIT | 700 | 701 | 211 | 156 | 138 | 196 | 225 | 715 | *753* | *775* |
| Gross interest | 361 | 362 | 88 | 88 | 92 | 94 | 90 | 364 | *350* | *371* |
| Net income (as reported) | 259 | 280 | 96 | 58 | 41 | 85 | 106 | 290 | *282* | *283* |
| **Cash Flow Summary** | | | | | | | | | | |
| **FFO** | 635 | 690 | 200 | 170 | 147 | 173 | 204 | 694 | *650* | *680* |
| Capital Expenditures | (904) | (1,024) | (219) | (277) | (267) | (261) | (188) | (993) | *(1,100)* | *(1,000)* |
| Preferred dividends | (14) | (18) | (4) | (5) | (5) | (4) | (6) | (20) | *(24)* | *(24)* |
| Dividends (common & non-cont.) | (177) | (143) | (47) | (46) | (48) | (2) | (98) | (194) | *(192)* | *(192)* |
| **Gross free cash flow (FCF)** | **(460)** | **(495)** | **(70)** | **(158)** | **(173)** | **(94)** | **(88)** | **(513)** | *(666)* | *(536)* |
| Changes in working capital | 41 | (41) | 31 | 108 | (80) | (100) | 45 | (27) | - | - |
| Gross FCF after working capital | (419) | (536) | (39) | (50) | (253) | (194) | (43) | (540) | *(666)* | *(536)* |
| Other investing activities | 50 | (21) | 9 | 5 | 16 | (51) | 12 | (18) | - | - |
| **Free cash flow before financing** | **(369)** | **(557)** | **(30)** | **(45)** | **(237)** | **(245)** | **(31)** | **(558)** | *(666)* | *(536)* |
| Debt issuance/(repayment) | (147) | 551 | 47 | 81 | 209 | 214 | (226) | 278 | *291* | *336* |
| Issue of common shares | 308 | 46 | 13 | 11 | 8 | 14 | 23 | 56 | *40* | *200* |
| Issue of preference shares | 223 | - | - | - | - | - | 242 | 242 | *250* | - |
| Other financing activities | 3 | (5) | - | - | (5) | - | - | (5) | - | - |
| F/X gain/(loss) | 3 | (4) | - | (1) | (2) | (1) | (1) | (5) | - | - |
| **Net increase (decrease) in cash** | **21** | **31** | **30** | **46** | **(27)** | **(18)** | **7** | **8** | *(85)* | - |
| **Capital Structure** | | | | | | | | | | |
| Total debt | 5,534 | 5,915 | 5,547 | 5,563 | 5,710 | 5,915 | 5,665 | 5,665 | *6,206* | *6,542* |
| Non-controlling interest | 145 | 123 | 148 | 137 | 124 | 123 | 118 | 118 | *123* | *123* |
| Preference Shares | 667 | 667 | 667 | 667 | 667 | 667 | 912 | 912 | *912* | *912* |
| Shareholders' equity | 3,046 | 3,193 | 3,116 | 3,120 | 3,100 | 3,193 | 3,212 | 3,212 | *3,323* | *3,614* |
| **Total capital** | **9,392** | **9,898** | **9,478** | **9,487** | **9,601** | **9,898** | **9,907** | **9,907** | **10,564** | **11,191** |
| Cash and equivalents | 66 | 85 | 94 | 137 | 106 | 85 | 92 | 92 | - | - |
| **Credit Ratios** | | | | | | | | | | |
| Total Debt / Capital[1] | 62.5% | 63.1% | 62.0% | 62.2% | 62.9% | 63.1% | 61.8% | 61.8% | *63.1%* | *62.5%* |
| Net Debt / Capital[1] | 62.2% | 62.8% | 61.7% | 61.6% | 62.5% | 62.8% | 61.4% | 61.4% | *63.1%* | *62.5%* |
| EBITDA / interest | 2.9x | 2.9x | 2.9x | 3.0x | 3.0x | 2.9x | 3.0x | 3.0x | *3.2x* | *3.2x* |
| EBIT / interest | 1.9x | 1.9x | 1.9x | 2.0x | 1.9x | 1.9x | 2.0x | 2.0x | *2.2x* | *2.1x* |
| Total Debt / EBITDA | 5.3x | 5.6x | 5.3x | 5.2x | 5.3x | 5.6x | 5.2x | 5.2 | *5.5* | *5.6* |
| FFO / Total Debt | 11.5% | 11.7% | 11.6% | 11.9% | 11.9% | 11.7% | 12.3% | 12.3% | *10.5%* | *10.4%* |

1. To calculate leverage ratios, we have attributed 50%/50% debt/equity treatment to Fortis Inc. preferred equity.

Source: Company reports, RBC Capital Markets Research

**Exhibit 3: Fortis Inc. and Subsidiary Bonds Outstanding**

| Issuer Name | Amount (C$ million) | Coupon | Maturity | Issue Date | Refund Type | Security |
|---|---|---|---|---|---|---|
| Fortis Inc. | 100 | 7.40% | 10/25/2010 | 10/18/2000 | Call +43 bps | Senior Unsecured |
| Fortis Inc. | 200 | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| **Total Fortis Inc.** | **300** | | | | | |
| | | | | | | |
| Terasen Inc. | 125 | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| Terasen Inc.^ | 125 | 8.00% | 04/19/2040 | 04/11/2000 | | Subordinated debentures |
| | | | | | | |
| Terasen Gas Vancouver | 250 | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| | | | | | | |
| BC Gas Utility* | 75 | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility* | 200 | 10.30% | 09/30/2016 | 11/8/1991 | Call +35 bps | Mortgage |
| BC Gas Utility* | 150 | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc. | 120 | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | 5.80% | 05/13/2038 | 05/8/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Inc. | 100 | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | |
| * Terasen Gas was formerly called BC Gas Utility. ^8.0% capital securities redeemed in April 2010. | | | | | | |
| FortisAlberta | 200 | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| **Total FortisAlberta** | **935** | | | | | |
| West Kootenay P&L | 15 | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| **Total FortisBC** | **490** | | | | | |
| Newfoundland Light & Power | 40 | 10.55% | 08/1/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | 10.90% | 05/2/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | 9.00% | 10/1/2020 | 09/8/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | 8.90% | 05/7/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | 6.80% | 11/20/2028 | 11/2/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | 7.52% | 11/1/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | |
| | | | | | | |
| **Maritime Electric** | **60** | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| | | | | | | |
| **Total Bonds Outstanding** | **4,238** | | | | | |

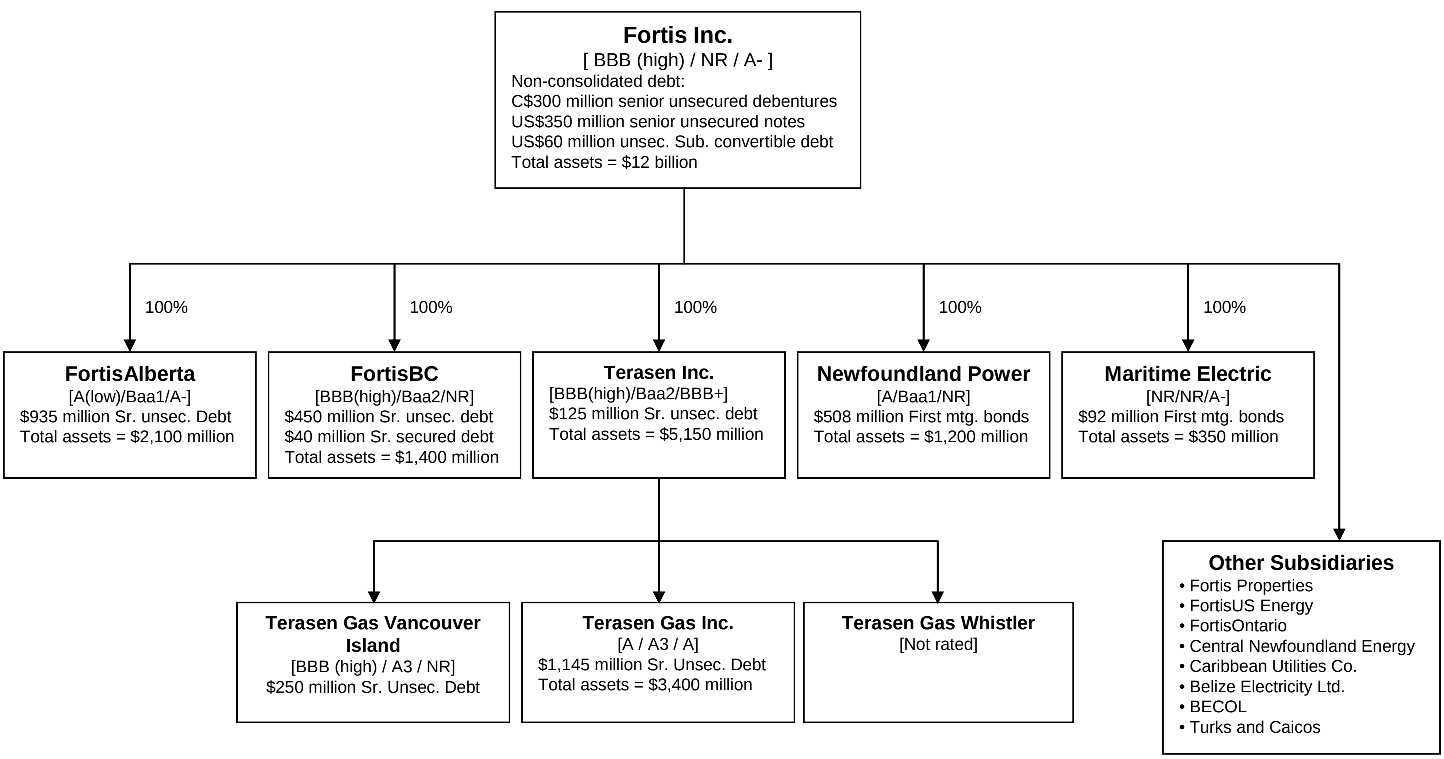
Source: Company reports, RBC Capital Markets Research

### Exhibit 4: Fortis Inc. Liquidity Summary ($ millions)

| Liquidity Summary: | 31-Mar-09 | 31-Dec-09 | 31-Mar-10 |
|---|---|---|---|
| Consolidated credit facilities | 2,230.0 | 2,153.0 | 2,151.0 |
| **Total credit facilities available** | **2,230.0** | **2,153.0** | **2,151.0** |
| Amounts drawn: | | | |
| Short-term borrowings | (261.0) | (415.0) | (233.0) |
| Long-term debt | (221.0) | (208.0) | (166.0) |
| Letters of credit outstanding | (104.0) | (100.0) | (117.0) |
| Total amounts drawn | (586.0) | (723.0) | (516.0) |
| **Available and uncommitted** | **1,644.0** | **1,430.0** | **1,635.0** |
| Cash & equivalents | 94.0 | 85.0 | 92.0 |
| **Total available liquidity** | **1,738.0** | **1,515.0** | **1,727.0** |

Source: Company reports, RBC Capital Markets Research

### Exhibit 5: Fortis Inc. Organizational Structure




Source: Company reports, RBC Capital Markets Research

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Distribution of Ratings
RBC Capital Markets, Credit Research

| Rating | Count | Percent | Investment Banking Serv./Past 12 Mos. Count | Investment Banking Serv./Past 12 Mos. Percent |
|---|---|---|---|---|
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| HOLD[SP] | 127 | 52.26 | 83 | 65.35 |
| SELL[U] | 44 | 18.11 | 25 | 56.82 |

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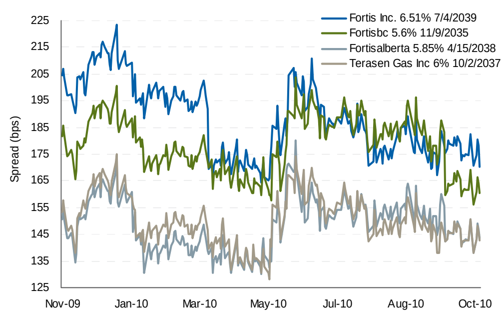
**Fortis Historical Spreads**




Source: ADI, RBC Capital Markets Research

**Fortis Inc. Credit Summary** ($million)

| Cash Flow Summary | 2009 | 2010E | 2011E | 2012E |
|---|---|---|---|---|
| EBITDA | 1,065 | *1,118* | *1,174* | *1,233* |
| **FFO** | **690** | *650* | *690* | *720* |
| Capital expenditures | (1,024) | *(1,100)* | *(1,200)* | *(1,200)* |
| Dividends | (161) | *(216)* | *(230)* | *(216)* |
| **Gross FCF** | **(495)** | *(666)* | *(740)* | *(696)* |
| Changes in w/c | (41) | - | - | - |
| FCF after w/c | (536) | *(666)* | *(740)* | *(696)* |
| Other investing | (21) | - | - | - |
| **FCF before financing** | **(557)** | *(666)* | *(740)* | *(696)* |
| Debt issuance/(repay.) | 551 | *291* | *500* | *456* |
| Common issuance | 46 | *40* | *40* | *40* |
| Preferred issuance | - | *250* | *200* | *200* |
| Other financing | (9) | - | - | - |
| **Net change in cash** | **31** | *(85)* | - | - |
| **Capital Structure** | | | | |
| Total debt | 5,915 | *6,206* | *6,706* | *7,161* |
| Non-controlling int. | 123 | *123* | *123* | *123* |
| Preference Shares | 667 | *912* | *1,112* | *1,312* |
| Shareholders' equity | 3,193 | *3,319* | *3,482* | *3,654* |
| **Total capital** | **9,898** | *10,560* | *11,422* | *12,251* |
| Cash and equivalents | 85 | - | - | - |
| **Credit Ratios** | | | | |
| Total Debt / Capital | 63% | *63%* | *64%* | *64%* |
| Net Debt / Capital | 63% | *63%* | *64%* | *64%* |
| EBITDA / interest | 2.9x | *3.2x* | *3.2x* | *3.1x* |
| EBIT / interest | 1.9x | *2.1x* | *2.2x* | *2.1x* |
| Total Debt / EBITDA | 5.6x | *5.5x* | *5.7x* | *5.8x* |
| FFO / Total Debt | 11.7% | *10.5%* | *10.3%* | *10.1%* |
| **Credit Ratios** | **DBRS** | **S&P** | **Moody's** | |
| Rating | A (low) | A- | NR | |
| Outlook | Stable | Stable | | |

Source: RBC Capital Markets, Company reports, Rating Agencies

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All values in Canadian dollar unless otherwise noted.

COMPANY UPDATE | COMMENT

**NOVEMBER 9, 2010**

# Fortis Inc.

## Q3/10: Improved Regulation Provides a Boost

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta** | **Sector Perform** |
| **FortisBC** | **Outperform** |
| **Terasen Gas** | **Sector Perform** |
| **Newfounland Power** | **Sector Perform** |

## Investment Thesis and Highlights

**Fortis reports Q3/10 (credit neutral):** Consolidated credit metrics were essentially unchanged from the previous quarter, with Debt/Capital at 62%, EBITDA/Interest at 3.1x and FFO/Debt at 12%. During the quarter, Fortis drew down on its various short term credit facilities to fund a $160MM gross free cash flow (FCF) shortfall, after capex of $268MM and dividends of $57MM. This compares to a gross FCF deficit of $173MM, after capex of $267 million and dividends of $53MM last year (Exhibit 5). Also during the quarter: (i) DBRS upgraded Fortis to A (low) from BBB (high), and Fortis finalized an agreement to develop the $900MM Waneta hydro electric plant (51% owned by Fortis).

**Earnings and cash flows up from positive regulatory decisions:** Consolidated EBITDA increased to $265MM in Q3/10 compared to $229MM last year, and FFO increased by 12% to $165MM compared to $147MM during the same period (Exhibit 5). The increase was primarily driven by higher contributions from its regulated business (higher allowed ROE, increased deemed equity and rate base growth), and Non-Regulated Fortis Generation assets, partially offset by lower results from Regulated Gas Utilities and higher Corporate costs.

**Capex of $5.5 billion over five years:** Fortis maintained its capex guidance of $1.1 billion for 2010. With $700MM spent year-to-date, about $400MM (35% of total) still remains in Q4/10. The large capex program is expected to be maintained over the next five years, with $5.5B forecast by management. In addition, Fortis remains on the hunt for a utility acquisition in the U.S. (+$1B).

**Continuing to access debt capital to fund growth:** Since the third quarter, Fortis has accessed the debt markets twice: (i) a US$250MM private placement by Fortis Inc. with funds likely used to pay down credit facilities and repay a $100MM maturity in October; and (ii) a $125MM 40-year note issued by FortisAlberta to help fund its capital program. We expect FortisBC to be the next in the group to access the debt markets, likely early next year for about $100MM.

**We still favour FortisBC bonds:** FortisBC bonds have tightened in 10 bps this year relative to the regulated utility peer group, and remain one of our favourite regulated utility bonds given the discount they continue to trade at relative to peers (Exhibit 4). We think the current discount that Fortis Inc. "holdco" bonds trade at compared to its regulated utility opco's provides investors with a decent yield pick-up (approx. +40 bps over FortisAlberta and Terasen Gas, and +30 bps over FortisBC) (Exhibit 1) to compensate for the structural subordination, especially when considering the diversified and stable source of cash flow generated by its group of utility subsidiaries. However, we highlight that the key risk in holding Fortis Inc. bonds is the potential risk of a sizable U.S. utility acquisition that would result in the issuance of a material amount of holdco debt. However, based on past acquisitions by Fortis Inc., we expect such a transaction to involve sufficient equity funding to maintain existing credit ratings. We think FortisAlberta bonds are fairly valued compared to regulated utility peers.

**Priced as of prior trading day's market close, EST (unless otherwise noted).**

**For Required Conflicts Disclosures, please see Page 11.**

## Highlights, continued:

- **We still favour FortisBC bonds:** FortisBC bonds have tightened in 10 bps this year relative to the regulated utility peer group. FortisBC bonds are still one of our favourite regulated utility bonds given the discount they continue to trade at relative to peers (Exhibit 4). We think the current discount that Fortis Inc. "holdco" bonds trade at compared to its regulated utility opco's provides investors with a favourable yield pick-up (approx. +40 bps over FortisAlberta and Terasen Gas, and +30 bps over FortisBC) (Exhibit 1) to compensate for the associated structural subordination, especially when considering the diversified and stable source of cash flow generated by its group of utility subsidiaries. However, we highlight that the key risk in holding Fortis Inc. holdco bonds is the potential risk of a sizable U.S. utility acquisition that would result in the issuance of a material amount of holdco debt. However, based on past transactions by Fortis Inc., we would expect such a transaction to involve sufficient equity funding to maintain existing credit ratings. We think FortisAlberta bonds are fairly valued compared to regulated utility peers.
- **Waneta expansion finalized:** In Q3/10, Fortis finalized an agreement to enter into a partnership with Columbia Power Corporation and Columbia Basin Trust to build a 335 MW Waneta Expansion ($900 million), a hydroelectric plant in B.C. Fortis will own 51% of and operate the plant. Power will be sold to BC Hydro and FortisBC under long-term contracts. Construction will start this month and the facility is expected to enter operation in the first half of 2015. Construction will initially be funded with credit facilities at the holdco level, with permanent financing expected once the plant nears completion.
- **Parent and Opco recently accessed the debt markets:** In October, Fortis accessed the debt markets twice. (1) Fortis Inc. completed a two-tranche US$250 million private placement (US$125 million 10s and US$75 million 30s), with proceeds likely used toward repaying the company's $100 million maturity in October, paying down credit facilities and equity injections down to its subsidiaries. (2) Fortis Alberta issued a $125 million 4.80% 40-year note at +135 bps, with proceeds likely being used to help fund the utility's capital program. Fortis also raised $19 million from its DRIP in Q3.
- **Adequate liquidity:** At the end of Q3/10, Fortis Inc. and its subsidiaries had $1.2 billion available on its $2.15 billion in consolidated credit facilities, compared to $1.4 billion available at the end of Q2/10 (Exhibit 4). This included roughly $386 million unused under the corporation's $600 million committed credit facility. These outstanding balances would have come down with repayments from proceeds from the above-noted debt issuance. The company had $64 million in cash and equivalents. We think this is more than adequate for the company's near-term requirements.
- **Dividend increase on the horizon:** Fortis has historically increased dividends annually. Our equity team is forecasting a dividend increase to $1.24/share in 2011 (from $1.12/share currently), implying a 70% payout. This would increase the annual cash payout by roughly $14 million to about $206 million before its DRIP. We think this is manageable.

## Outlook and Funding Expectations

- **$5.5 billion of capital spending over five years:** For 2010, consolidated capex is expected to be about $1.1 billion, with $700 million spent year-to-date mainly at its regulated utility subsidiaries. Over the next five years (2011 to 2015), capital spending on a consolidated basis is expected to reach $5.5 billion (including Waneta). The lion's share of the spending will be at its regulated utility subsidiaries, FortisAlberta and FortisBC, and Terasen Gas.
- **Utility rate base growth:** Fortis expects its combined utility rate base to grow to $9.4 billion in 2013, representing an average compound growth rate of 7%. Terasen Gas, FortisAlberta and FortisBC will be the key growth contributors.
- **Utility acquisitions a continued focus:** Management continues to look to acquire utility (gas and/or electric utilities or integrated including generation) assets with a size of $1 billion to $5 billion in enterprise value, although nothing is imminent. The company has indicated that an acquisition would have to be EPS accretive in the first year. Geographies of focus are in Canada and the U.S. We expect any material acquisition would be funded with a mix of debt and sufficient equity (common and preferreds) to maintain current credit ratings, based on how Fortis has handled past transactions.
- **Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis over the next few years in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. The upcoming debt maturity by the Fortis issuing entities is fairly light, with the next maturity not until 10/16/12 – a small $15 million maturity at FortisBC (Exhibit 8).
  - **Fortis Inc.:** Has accessed the capital markets twice this year: (i) $250 million in cumulative redeemable preference shares (January), with funds used to inject $125 million of equity into Terasen Gas and pay down credit facilities; and (ii) a US$200 million private placement (October) with proceeds partly used to refinance a $100 million debt maturity. We do not expect additional funding by Fortis for the remainder of this year.
  - **Terasen Gas:** Received an equity injection of $125 million from Fortis Inc. in Q1/10 to boost Terasen Gas' deemed equity base to 40% (from 35%) in response to a recent regulatory decision. Proceeds from the Fortis equity injection were used to pay down credit facility balances in Q1/10. During Q3/10, Terasen Gas drew $92 million on its credit facilities, mainly to build gas

inventories, bringing the balance outstanding to $135 million at quarter's end. We are not expecting Terasen Gas to access the debt markets until well into next year.

- **FortisAlberta:** We had forecasted that FortisAlberta would need roughly $160 million in debt, plus a $50 million equity injection from Fortis, to fund its $365 million capital program in 2010. As at the end of Q3/10, FortisAlberta had increased its debt by approximately $80 million (brining amounts outstanding on credit facilities to $104 million), and received $40 million in equity injections from Fortis. Leverage was at 57%, just under the 59% deemed by regulation. FortisAlberta issued a $125 million 40-year MTN in October to pay down balances owing on credit facilities.
- **FortisBC:** We had forecasted that FortisBC would need just under $100 million in debt, plus a $10 million equity injection from Fortis, to fund its $160 million capital program in 2010. At the end of Q3/10, FortisBC had $62 million outstanding on credit facilities (out of $150 million available), and has not yet received an equity injection from Fortis in 2010. Its leverage was at 59%, just under the 60% regulatory level. We expect to see FortisBC in the debt market in the next couple of quarters to term-out its credit facility balance, which could exceed $100 million by year-end. For 2011 we are expecting about $65 million in debt and $15 million in equity injections, assuming $150 million in capex.
- **Newfoundland Power:** We expect Newfoundland Power to generate sufficient cash flow to fund its 2010 capital program.

**Exhibit 1: Corporate and Subsidiary Funding Expectations for 2010 ($ millions)**

| Entity | Equity Required[1] | New Debt Required | Debt Maturities | Drawn on Credit Facilities (12/31/09) | Total Debt Issuance Expected[2] | Total Funding Expected[3] | Debt Issued to Date (09/30/10) | Equity Issued to Date (09/30/10) | Preferred Equity Issued to Date (09/30/10) | Capital Raised to Date (09/30/10) |
|---|---|---|---|---|---|---|---|---|---|---|
| Fortis Inc. | 175 | 91 | 100 | 124 | 300 | **475** | 200 | 58 | 250 | **508** |
| Subsidiaries: | | | | | | | | | | |
| FortisAlberta | 50 | 158 | 0 | 22 | 150 | **200** | 125 | 40 | 0 | **165** |
| FortisBC | 10 | 88 | 0 | 35 | 100 | **110** | 0 | 0 | 0 | **0** |
| Newfoundland Power | 0 | 15 | 0 | 14 | 0 | **0** | 0 | 0 | 0 | **0** |
| Terasen Gas | 125 | -61.1 | 0 | 204 | -60 | **65** | 0 | 125 | 0 | **125** |

1. Fortis Inc. raises either common equity (including DRIP) or preferreds in public markets. Subsidiaries receive equity injections from Fortis Inc.

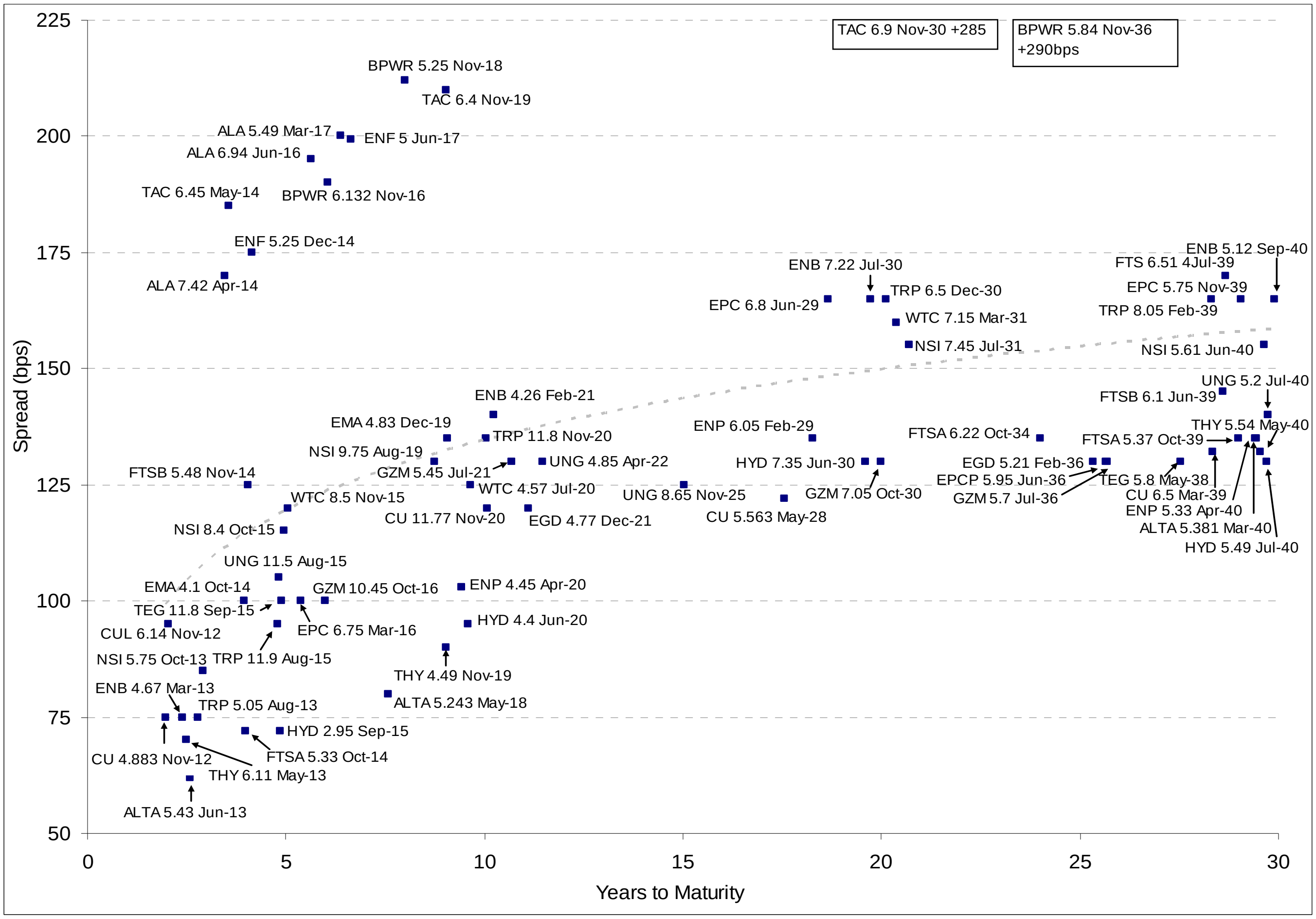
2. Debt issuance rounded to nearest increment of $25 million.

3. Total funding expected = Equty Required + Total debt issuance expected.

For detailed financial forecasts of each subsidiary, refer to report titled "Utilities in Canada: A Credit Outlook" dated March 29, 2010.

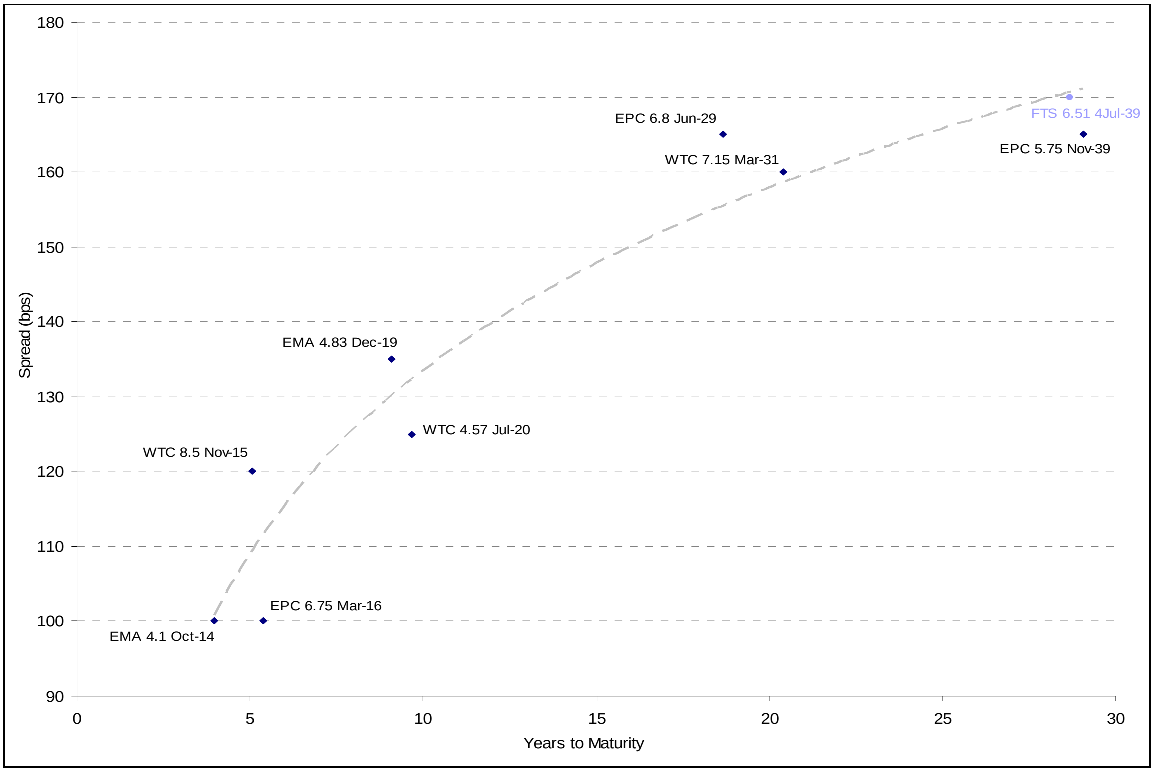
Source: RBC Capital Markets Research and Company Reports

**Exhibit 2: Relative Value Chart - Canadian Utilities and Pipelines**



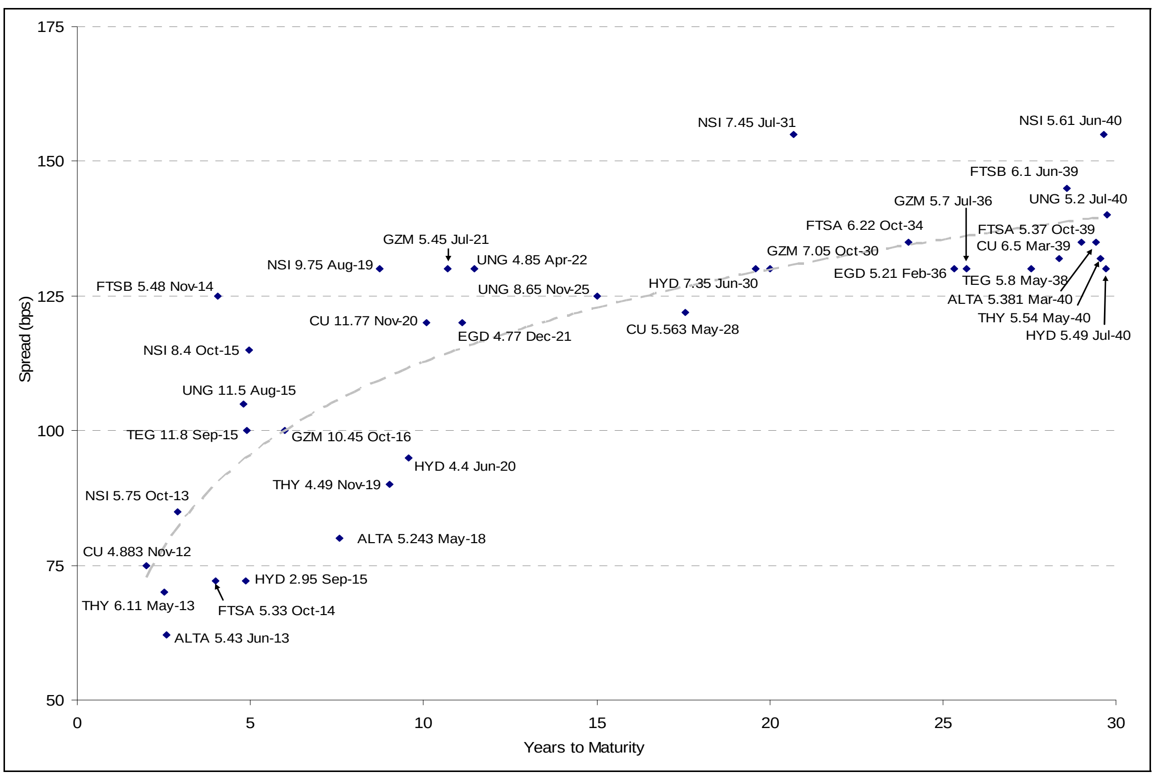

Source: RBC Capital Markets Research

**Exhibit 3: Relative Value Chart - Canadian Utility Holding Companies**




Source: RBC Capital Markets Research

**Exhibit 4: Relative Value Chart - Canadian Regulated Utilities**




Source: RBC Capital Markets Research

### Exhibit 5: Fortis Inc Historical Financials and Forecasts

| Fortis Inc ($million) | Annual | | Quarterly | | | | | | | Forecasts | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Earnings Summary** | **2008** | **2009** | **Q3/09** | **Q4/09** | **Q1/10** | **Q2/10** | **Q3/10** | **LTM** | **YTD** | *2010E* | *2011E* | *2012E* |
| EBITDA | 1,048 | 1,065 | 229 | 286 | 322 | 267 | 265 | 1,140 | 854 | *1,118* | *1,174* | *1,233* |
| EBIT | 700 | 701 | 138 | 196 | 225 | 169 | 148 | 738 | 542 | *747* | *808* | *833* |
| Gross interest | 361 | 362 | 92 | 94 | 90 | 89 | 92 | 365 | 271 | *350* | *371* | *401* |
| Net income (as reported) | 259 | 280 | 41 | 85 | 106 | 63 | 52 | 306 | 221 | *278* | *328* | *324* |
| **Cash Flow Summary** | | | | | | | | | | | | |
| **FFO** | 635 | 690 | 147 | 173 | 204 | 160 | 165 | 702 | 529 | *650* | *690* | *720* |
| Capital Expenditures | (904) | (1,024) | (267) | (261) | (188) | (244) | (268) | (961) | (700) | *(1,100)* | *(1,200)* | *(1,200)* |
| Preferred dividends | (14) | (18) | (5) | (4) | (6) | (8) | (7) | (25) | (21) | *(24)* | *(24)* | *(24)* |
| Dividends (common & non-cont.) | (177) | (143) | (48) | (2) | (98) | (51) | (50) | (201) | (199) | *(192)* | *(206)* | *(192)* |
| **Gross free cash flow (FCF)** | **(460)** | **(495)** | **(173)** | **(94)** | **(88)** | **(143)** | **(160)** | **(485)** | **(391)** | *(666)* | *(740)* | *(696)* |
| Changes in working capital | 41 | (41) | (80) | (100) | 45 | 44 | (36) | (47) | 53 | *-* | *-* | *-* |
| Gross FCF after working capital | (419) | (536) | (253) | (194) | (43) | (99) | (196) | (532) | (338) | *(666)* | *(740)* | *(696)* |
| Other investing activities | 50 | (21) | 16 | (51) | 12 | 15 | 15 | (9) | 42 | *-* | *-* | *-* |
| **Free cash flow before financing** | **(369)** | **(557)** | **(237)** | **(245)** | **(31)** | **(84)** | **(181)** | **(541)** | **(296)** | *(666)* | *(740)* | *(696)* |
| Debt issuance/(repayment) | (147) | 551 | 209 | 214 | (226) | 45 | 155 | 188 | (26) | *291* | *500* | *456* |
| Issue of common shares | 308 | 46 | 8 | 14 | 23 | 16 | 19 | 72 | 58 | *40* | *40* | *40* |
| Issue of preference shares | 223 | - | - | - | 242 | - | - | 242 | 242 | *250* | *200* | *200* |
| Other financing activities | 3 | (5) | (5) | - | - | 1 | - | 1 | 1 | *-* | *-* | *-* |
| F/X gain/(loss) | 3 | (4) | (2) | (1) | (1) | 1 | - | (1) | - | *-* | *-* | *-* |
| **Net increase (decrease) in cash** | **21** | **31** | **(27)** | **(18)** | **7** | **(21)** | **(7)** | **(39)** | **(21)** | *(85)* | - | - |
| **Capital Structure** | | | | | | | | | | | | |
| Total debt | 5,534 | 5,915 | 5,710 | 5,915 | 5,665 | 5,742 | 5,875 | 5,875 | | *6,206* | *6,706* | *7,161* |
| Non-controlling interest | 145 | 123 | 124 | 123 | 118 | 125 | 122 | 122 | | *123* | *123* | *123* |
| Preference Shares | 667 | 667 | 667 | 667 | 912 | 912 | 912 | 912 | | *912* | *1,112* | *1,312* |
| Shareholders' equity | 3,046 | 3,193 | 3,100 | 3,193 | 3,212 | 3,248 | 3,255 | 3,255 | | *3,319* | *3,482* | *3,654* |
| **Total capital** | **9,392** | **9,898** | **9,601** | **9,898** | **9,907** | **10,027** | **10,164** | **10,164** | | **10,560** | **11,422** | **12,251** |
| Cash and equivalents | 66 | 85 | 106 | 85 | 92 | 71 | 64 | 64 | | - | - | - |
| **Credit Ratios**[1] | | | | | | | | | | | | |
| Total Debt / Capital | 62.5% | 63.1% | 62.9% | 63.1% | 61.8% | 61.8% | 62.3% | 62.3% | | *63.1%* | *63.6%* | *63.8%* |
| Net Debt / Capital | 62.2% | 62.8% | 62.5% | 62.8% | 61.4% | 61.5% | 62.0% | 62.0% | | *63.1%* | *63.6%* | *63.8%* |
| (FFO + interest) / interest | 2.8x | 2.9x | 2.9x | 2.9x | 2.9x | 2.9x | 2.9x | 2.9x | | *2.9x* | *2.9x* | *2.8x* |
| EBITDA / interest | 2.9x | 2.9x | 3.0x | 2.9x | 3.0x | 3.0x | 3.1x | 3.1x | | *3.2x* | *3.2x* | *3.1x* |
| EBIT / interest | 1.9x | 1.9x | 1.9x | 1.9x | 2.0x | 2.0x | 2.0x | 2.0x | | *2.1x* | *2.2x* | *2.1x* |
| Total Debt / EBITDA | 5.3x | 5.6x | 5.3x | 5.6x | 5.2x | 5.2x | 5.2x | 5.2 | | *5.5* | *5.7* | *5.8* |
| FFO / Total Debt | 11.5% | 11.7% | 11.9% | 11.7% | 12.3% | 11.9% | 11.9% | 11.9% | | *10.5%* | *10.3%* | *10.1%* |

1. To calculate leverage ratios, we have attributed 50%/50% debt/equity treatment to Fortis Inc. preferred equity.

Source: Company reports, RBC Capital Markets Research

**Exhibit 6: Fortis Inc Liquidity Summary ($ millions)**

| Liquidity Summary - Fortis Inc: | Corporate and Other | Regulated Utilities | Fortis Properties | Q3/10 |
|---|---|---|---|---|
| Total Credit Facilities | 645.0 | 1,453.0 | 13.0 | 2,111.0 |
| Credit Facilities Utilized: | | | | |
| Short-term Borrowings | - | (340.0) | (1.0) | (341.0) |
| Long-term Debt (incl current portion) | (214.0) | (244.0) | - | (458.0) |
| Letters of Credit Outstanding | (1.0) | (111.0) | - | (112.0) |
| **Credit Facilities Available** | **430.0** | **758.0** | **12.0** | **1,200.0** |
| Cash & equivalents | | | | 64.0 |
| **Total Available Liquidity** | | | | **1,264.0** |

Source: Company reports, RBC Capital Markets Research

**Exhibit 7: Liquidity Summary - Subsidiaries ($ millions)**

| Liquidity Summary - Subs: | Q3/10 |
|---|---|
| **FortisAlberta Inc** | |
| Unsecured Credit Facility (May, 2012) | 200.0 |
| Unsecured Demand Loan | 10.0 |
| Credit Facility Utilized | (146.1) |
| Unsecured Demand Loan Utilized | (3.9) |
| **Credit Facilities Available** | **60.0** |
| Cash & equivalents | - |
| **Total Available Liquidity** | **60.0** |
| | |
| **FortisBC Inc** | |
| Revolving Credit Facility (May, 2013) | 100.0 |
| 364-Day Revolving Facility (May, 2011) | 50.0 |
| Demand Overdraft Facility | 10.0 |
| Utilized | (71.0) |
| **Credit Facilities Available** | **89.0** |
| Cash & equivalents | 0.0 |
| **Total Available Liquidity** | **89.0** |
| | |
| **Terasen Gas Inc** | |
| Total Credit Facilities | 500.0 |
| Short-term Borrowings | (135.0) |
| Letters of credit outstanding | (44.7) |
| **Credit Facilities Available** | **320.3** |
| Cash & equivalents | **8.3** |
| **Total Available Liquidity** | **328.6** |
| | |
| **Newfoundland Power Inc** | |
| Total Credit Facilities | 120.0 |
| Borrowing, Committed Facility | (8.0) |
| **Credit Facilities Available** | **112.0** |
| Cash & equivalents | 2.4 |
| **Total Available Liquidity** | **114.4** |

Source: Company reports, RBC Capital Markets Research

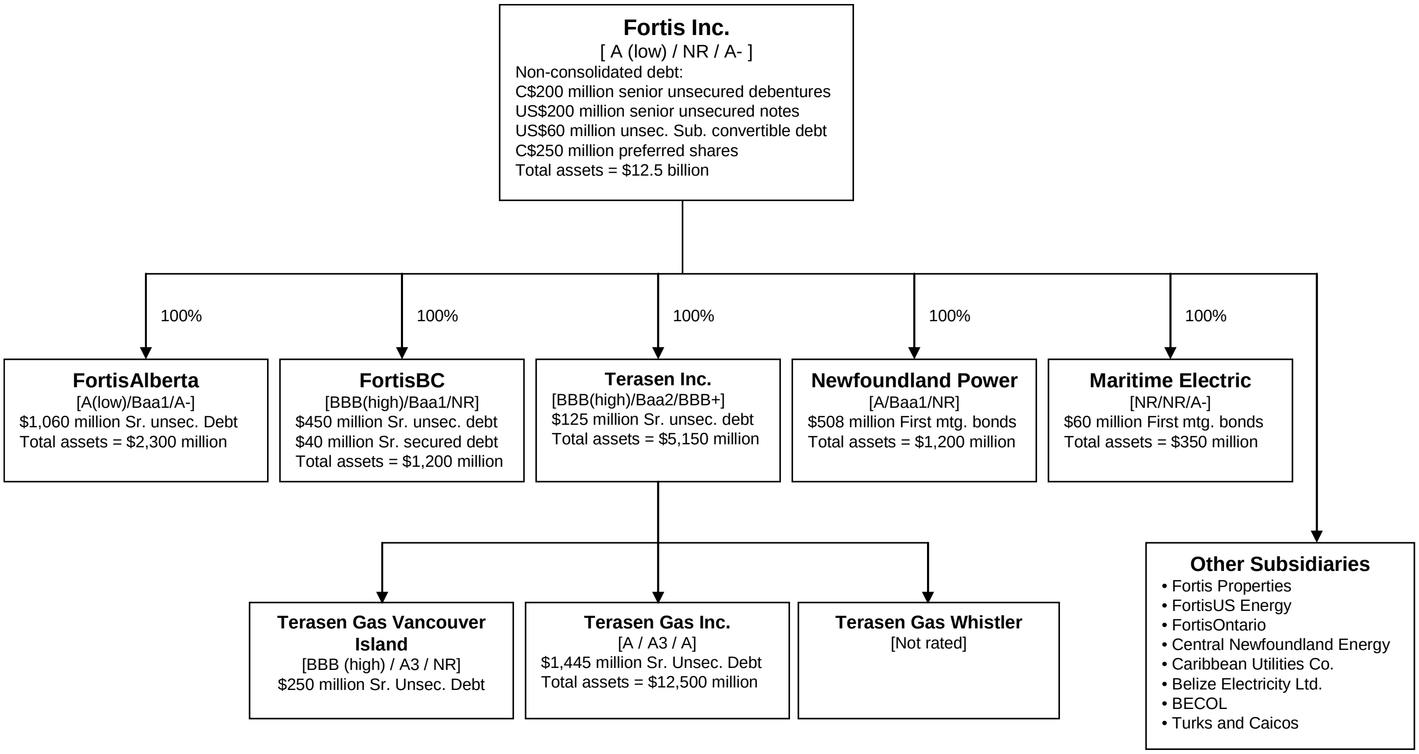
### Exhibit 8: Fortis Inc and Subsidiary Bonds Outstanding

| Issuer Name | Amount ($ million) | Currency | Coupon | Maturity | Issue Date | Refund Type | Security |
|---|---|---|---|---|---|---|---|
| Fortis Inc.[1] | 125 | USD | 3.53% | 10/18/2020 | 10/18/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc.[1] | 75 | USD | 5.26% | 10/18/2040 | 10/18/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **400** | | | | | | |
| | | | | | | | |
| Terasen Inc. | 125 | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| Terasen Inc.[2] | 125 | CAD | 8.00% | 04/19/2040 | 04/11/2000 | | Subordinated debentures |
| | | | | | | | |
| Terasen Gas Vancouver | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| | | | | | | | |
| BC Gas Utility[3] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[3] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[3] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc. | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Inc. | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | | |
| | | | | | | | |
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **935** | | | | | | |
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| **Total FortisBC** | **490** | | | | | | |
| Newfoundland Light & Power | 40 | CAD | 10.55% | 08/1/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.90% | 05/2/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 9.00% | 10/1/2020 | 09/8/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 8.90% | 05/7/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | CAD | 6.80% | 11/20/2028 | 11/2/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | CAD | 7.52% | 11/1/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | | |
| | | | | | | | |
| **Maritime Electric** | **60** | CAD | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| | | | | | | | |
| **Total Bonds Outstanding** | **4,338** | | | | | | |

1. USD Private placements. 2. 8.0% capital securities redeemed in April 2010. 3. Terasen Gas was formerly called BC Gas Utility.

Source: Company reports, RBC Capital Markets Research

**Exhibit 9: Fortis Inc Organizational Structure**




Source: Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities (see organizational structure in Exhibit 9) provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. Cash inflows from its subsidiaries are expected to exceed $190 million annually. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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**Outperform (O):** Provides superior relative risk-reward ratio and/or is expected to materially outperform the sector average over 12 months.

**Sector Perform (SP):** Provides an adequate relative risk-reward ratio and/or total return is expected to be in line with the sector average over 12 months.

**Underperform (U):** Provides an inferior relative risk-reward ratio and/or total return is expected to be materially below the sector average over 12 months.

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**RBC Capital Markets, Credit Research**

| | | | Investment Banking Serv./Past 12 Mos. | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| BUY[TP/O] | 58 | 33.92 | 28 | 48.28 |
| HOLD[SP] | 79 | 46.20 | 44 | 55.70 |
| SELL[U] | 34 | 19.88 | 17 | 50.00 |

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# RBC Capital Markets®

CREDIT | RESEARCH

COMPANY UPDATE | **CANADIAN CREDIT COMMENT**

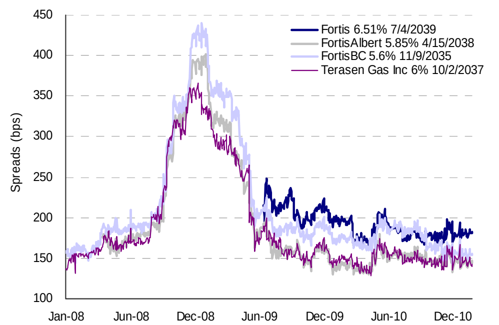
**FEBRUARY 11, 2011**

## Fortis Inc.

### Q4/10: Improved Regulation Continues to Provide Boost

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta** | **Sector Perform** |
| **FortisBC** | **Outperform** |
| **Terasen Gas** | **Sector Perform** |
| **Newfoundland Power** | **Sector Perform** |

**Fortis Historical Spreads**




Source: ADI, RBC Capital Markets Research

**Fortis Inc. Credit Summary** ($million)

| **Cash Flow Summary** | **2009** | **2010** | ***2011E*** | ***2012E*** |
|---|---|---|---|---|
| EBITDA | 1,065 | 1,150 | *1,231* | *1,304* |
| **FFO** | **690** | **734** | ***740*** | ***790*** |
| Capital expenditures | (1,024) | (1,073) | *(1,212)* | *(1,072)* |
| Dividends | (161) | (281) | *(227)* | *(235)* |
| **Gross FCF** | **(495)** | **(620)** | ***(699)*** | ***(517)*** |
| Changes in w/c | (41) | 49 | - | - |
| FCF after w/c | (536) | (571) | *(699)* | *(517)* |
| Other investing | (21) | 82 | - | - |
| **FCF before financing** | **(557)** | **(489)** | ***(699)*** | ***(517)*** |
| Debt issuance/(repay.) | 551 | 146 | *320* | *247* |
| Common issuance | 46 | 80 | *70* | *70* |
| Preferred issuance | - | 242 | *200* | *200* |
| Other financing | (9) | 45 | - | - |
| **Net change in cash** | **31** | **24** | ***(109)*** | **-** |
| **Capital Structure** | | | | |
| Total debt | 5,915 | 6,023 | *6,343* | *6,589* |
| Non-controlling int. | 123 | 162 | *162* | *162* |
| Preference Shares | 667 | 912 | *1,112* | *1,312* |
| Shareholders' equity | 3,193 | 3,305 | *3,566* | *3,835* |
| **Total capital** | **9,898** | **10,402** | ***11,183*** | ***11,898*** |
| Cash and equivalents | 85 | 109 | - | - |
| **Credit Ratios** | | | | |
| Total Debt / Capital | 63% | 62% | *62%* | *61%* |
| Net Debt / Capital | 63% | 62% | *62%* | *61%* |
| EBITDA / interest | 2.9x | 3.2x | *3.4x* | *3.4x* |
| EBIT / interest | 1.9x | 2.1x | *2.4x* | *2.4x* |
| Total Debt / EBITDA | 5.6x | 5.2x | *5.2x* | *5.1x* |
| FFO / Total Debt | 11.7% | 12.2% | *11.7%* | *12.0%* |
| **Credit Ratios** | **DBRS** | **S&P** | **Moody's** | |
| Rating | A (low) | A- | NR | |
| Outlook | Stable | Stable | | |

Source: Company reports, Rating Agencies, RBC Capital Markets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All values in Canadian dollar unless otherwise noted.

## Investment Thesis and Highlights

**Fortis reports Q4/10 (credit neutral):** Consolidated credit metrics were essentially unchanged from the previous quarter, with debt/capital at 62%, EBITDA/interest at 3.2x and FFO/debt at 12%. Consolidated EBITDA increased to $301MM in Q4/10 compared to $286MM last year, and FFO increased by 21% to $209MM compared to $173MM during Q4/09 (Exhibit 5). The increase was primarily driven by higher contributions from its regulated business (higher allowed ROE, increased deemed equity and rate base growth) and non-regulated generation, partially offset by lower results from Terasen Gas.

**FCF shortfall funded with debt:** During Q4/10, Fortis generated a gross FCF shortfall of $222MM, after capex of $370MM and dividends of $61MM. This compares to a gross FCF deficit of $94MM, after capex of $261MM and dividends of $6MM in Q4/09 (Exhibit 5). The shortfall was funded with debt.

**Active in the debt markets:** During the fourth quarter, Fortis and its subsidiaries issued $525MM in debt in 5 tranches, and Fortis Inc. issued of $250MM in preferred shares. For 2011, we expect in the order of $350MM to be issued by Fortis' subsidiaries to help fund its capex program (Exhibit 1). We also expect Fortis Inc. will look to the preferred share market again in 2011.

**Capex of $5.5 billion over five years:** Capex in 2010 hit a record $1.1B, and is expected to reach $1.2B in 2011. Fortis expects a large capex program over the next five years, in the order of $5.5B forecast. In addition, Fortis remains on the hunt for a utility acquisition in the U.S. with enterprise value of $1.0B to $5.0B.

**Merging the BC gas utilities:** Fortis intends to file an application with the BC regulator this year to amalgamate Terasen Gas (TGI), Terasen Gas Vancouver Island (TGVI), and Terasen Gas Whistler. If approved, the three utilities would form one legal entity, and the bonds issued by TGVI and TGI would rank parri passu and likely trade together. TGVI bonds currently trade at roughly a 20 bps discount to TGI long bonds.

**Holdco bonds offer favourable pick-up:** We think the discount that Fortis Inc. "holdco" bonds trade at, relative to the company's regulated utility opco's, provides a favourable spread pick-up (30 to 35 bps) to compensate for the structural subordination, especially when considering the diversified and stable source of cash flow generated by its utility subsidiaries. We highlight the key risk in holding Fortis Inc. bonds is the potential for a sizable U.S. utility acquisition that would result in the issuance of a material amount of holdco debt. However, based on past acquisitions by Fortis Inc., we expect such a transaction to involve sufficient equity to maintain existing credit ratings.

**FortisBC bonds still offer good value:** FortisBC outperformed the regulated utility peer group in 2010. While the discount offered by FortisBC bonds is not as favourable as in the past, we continue to like these bonds given there is still a 5bps pick-up to most regulated utility peers and only minimal incremental credit risk.

**Priced as of prior trading day's market close, EST (unless otherwise noted).**

**For Required Conflicts Disclosures, please see Page 9.**

## Highlights, continued:

- **Rates set for 2011:** Customer rates have been set, effective January 1, 2011 at Fortis' four largest utilities, with allowed ROE's unchanged at Terasen Gas (9.5%), FortisBC (9.9%) and FortisAlberta (9.0%). The allowed ROE at FortisAlberta has been declared interim pending regulatory review currently underway. Newfoundland Power's ROE has decreased to 8.38% for 2011 from 9.0% in 2010, based on automatic-adjustment formula.
- **Dividend increased by 3.6%:** In December 2010, Fortis announced a quarterly dividend increase to $0.29/share from $0.28/share effective in Q1/10. This equates to an annual cash payout of roughly $202MM before its DRIP, an increase of $7MM over last year, which we think this is manageable.
- **Active in the debt markets last year:** In 2010, Fortis and its subsidiaries issued $525MM in new debt in 5 tranches: (1) Fortis Inc. completed a two-tranche US$200MM private placement (US$125MM 10s and US$75MM 30s) in December, with proceeds used to pay down credit facilities used to repay a $100MM maturity in October and likely to fund equity injections down to its subsidiaries. (2) Fortis Alberta issued a $125MM 4.80% 40-year note at +135 bps in October, with proceeds used to help fund the utility's capital program. (3) FortisBC issued a $100MM 5.0% 40-year note at 135 bps in November, with proceeds used to help fund capex. (4) TGVI issued a $100MM 5.20% 30-year note at 160 bps in December. We note that Fortis also issued $250MM in cumulative redeemable preference shares (January 2010), with funds used to inject $125MM of equity into Terasen Gas and pay down credit facilities.
- **Adequate liquidity:** At the end of Q4/10, Fortis Inc. and its subsidiaries had $1.4B available on its $2.1B in consolidated credit facilities, compared to $1.2B available at the end of Q3/10 (Exhibit 2). This included roughly $480MM unused under the corporation's $645MM committed credit facility. The company also had $109MM in cash and equivalents. We think this is more than adequate for the company's near-term requirements.

## Outlook and Funding Expectations

- **$5.5 billion of capital spending over five years:** For 2010, consolidated capex hit a record $1.1B (in line with guidance), $969MM spent at the company's regulated utility subsidiaries. Over the next five years (2011 to 2015), capital spending on a consolidated basis is expected to reach $5.5 billion. This includes the $900MM 335MW Waneta hydroelectric plant in BC being developed in JV with Columbia Power Corporation and the Columbia Basin Trust (51% controlling interest by Fortis). The lion's share of the spending will be at its regulated utility subsidiaries, FortisAlberta and FortisBC, and Terasen Gas. Fortis expects consolidated capex to reach $1.2B in 2011, with $1.0B being spent at its regulated utilities.
- **Utility acquisitions a continued focus:** Management continues to look to acquire utility (gas and/or electric utilities or integrated including generation) assets with a size of $1 billion to $5 billion in enterprise value. Management had indicated that it came close to a transaction in 2010, but lost out to a higher bidder. At this point, nothing appears imminent. The company has stated that an acquisition would have to be EPS accretive in the first year. Geographies of focus are in Canada and the U.S. We expect any material acquisition would be funded with a mix of debt and sufficient equity (common and preferreds) to maintain current credit ratings, based on how Fortis has handled large transactions in the past (such as Terasen Gas, and FortisAlberta and FortisBC).
- **Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis over the next few years in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. Fortis and its subsidiaries do not have any bond maturities in 2011 (Exhibit 6), so any new issuance this year will be to fund capex.
  - **Fortis Inc.:** For 2011, we are forecasting that at the holdco level, Fortis Inc. will need to issue roughly $200MM in preferred shares in 2011 in order to maintain balance sheet leverage near current levels and fund corporate level activities. We expect borrowing at the holdco level to be minimal. In 2010, Fortis Inc. accessed the capital markets twice: (i) $250MM in cumulative redeemable preference shares (January); and (ii) a US$200MM private placement. We do not expect additional funding by Fortis for the remainder of this year.
  - **Terasen Gas:** We are forecasting that Terasen Gas will need roughly $100MM in debt, plus a small equity injection in the range of 20% in 2011 in order to fund its $281MM capital program (the most significant item in Terasen Gas' capex program in 2011 is the LNG storage facility at TGVI). In 2010, Terasen Gas received an equity injection of $125MM from Fortis Inc. in Q1/10 to boost Terasen Gas' deemed equity base to 40% (from 35%) in response to a recent regulatory decision, and issued TGVI issued $100MM in debt.
  - **FortisAlberta:** We are forecasting that FortisAlberta will need roughly $200MM in debt, plus a $50MM equity injection from Fortis, to fund its $420MM capital program in 2011. In 2010, FortisAlberta issued $125MM in debt and had received $40MM in equity contributions from Fortis Inc. as at the end of Q3/10.
  - **FortisBC:** We are forecasting that FortisBC will need approximately $20MM in debt, plus a $10MM equity injection from Fortis, to fund its $99M capital program in 2010. In 2010, FortisBC issued $100MM in debt and not received an equity contribution from Fortis Inc. as at the end of Q3/10.

- **Newfoundland Power:** We expect Newfoundland Power to generate sufficient cash flow to fund its 2011 capital program, similar to 2010. In addition, Newfoundland is expecting to receive $46MM from the sale of joint-use poles to Bell Alliant in 2011.

**Exhibit 1: Capital Spending by Subsidiary ($ millions)**

| | Terasen Gas Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| 2011F | 281 | 420 | 99 | 73 | 46 | **919** | 83 | 183 | 27 | **1,212** |
| 2010A | 253 | 379 | 139 | 78 | 48 | **897** | 72 | 85 | 19 | **1,073** |

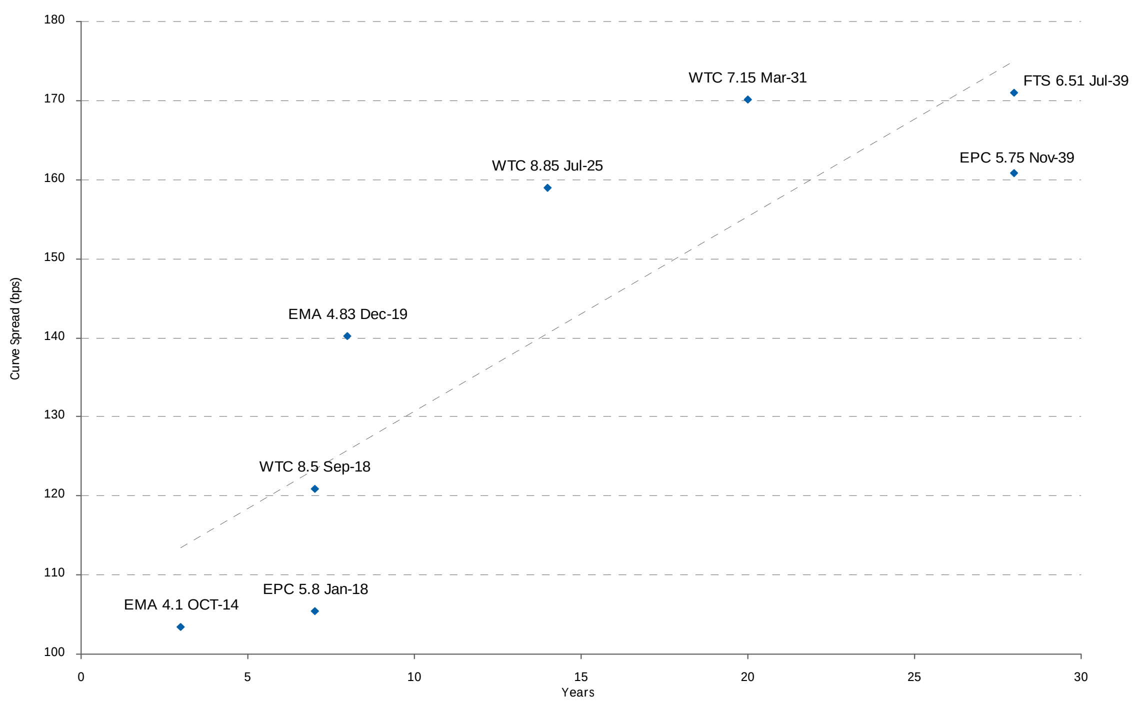
Source: Company reports

**Exhibit 2: Fortis Inc Liquidity Summary ($ millions)**

| Liquidity Summary - Fortis Inc: | Corporate and Other | Regulated Utilities | Fortis Properties | Q4/10 |
|---|---|---|---|---|
| Total Credit Facilities | 645.0 | 1,451.0 | 13.0 | 2,109.0 |
| Credit Facilities Utilized: | | | | |
| Short-term Borrowings | - | (351.0) | (7.0) | (358.0) |
| Long-term Debt (incl current portion) | (165.0) | (53.0) | - | (218.0) |
| Letters of Credit Outstanding | (1.0) | (122.0) | (1.0) | (124.0) |
| **Credit Facilities Available** | **479.0** | **925.0** | **5.0** | **1,409.0** |
| Cash & equivalents | | | | 109.0 |
| **Total Available Liquidity** | | | | **1,518.0** |

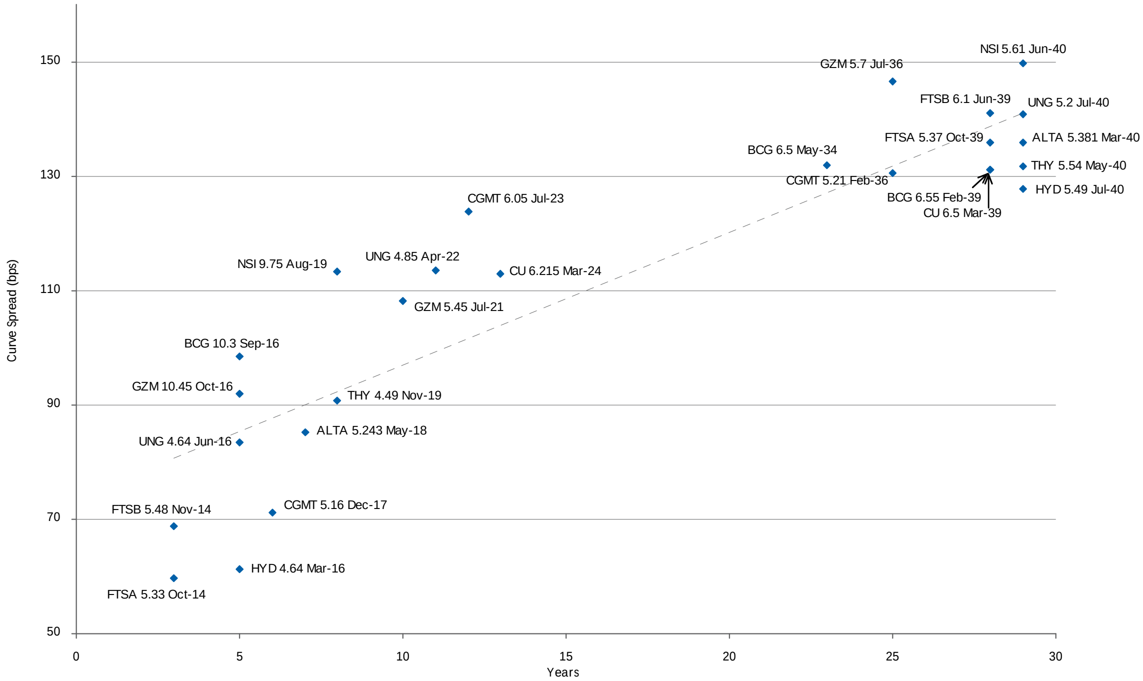
Source: Company reports, RBC Capital Markets Research

**Exhibit 3: Relative Value Chart - Canadian Utility Holding Companies**




Source: RBC Capital Markets Research

**Exhibit 4: Relative Value Chart - Canadian Regulated Utilities**




Source: RBC Capital Markets Research

**Exhibit 5: Fortis Inc. Historical Consolidated Financials and Forecasts**

| Fortis Inc ($million) | Annual | | Quarterly | | | | | Forecasts | |
|---|---|---|---|---|---|---|---|---|---|
| **Earnings Summary** | **2009** | **2010** | **Q4/09** | **Q1/10** | **Q2/10** | **Q3/10** | **Q4/10** | ***2011E*** | ***2012E*** |
| EBITDA | 1,065 | 1,150 | 286 | 322 | 267 | 265 | 301 | *1,231* | *1,304* |
| EBIT | 701 | 740 | 196 | 225 | 169 | 148 | 198 | *880* | *919* |
| Gross interest | 362 | 358 | 94 | 90 | 89 | 92 | 87 | *360* | *379* |
| Net income (as reported) | 280 | 313 | 85 | 106 | 63 | 52 | 92 | *390* | *405* |
| **Cash Flow Summary** | | | | | | | | | |
| **FFO** | 690 | 734 | 173 | 204 | 160 | 165 | 209 | ***740*** | ***790*** |
| Capital Expenditures | (1,024) | (1,073) | (261) | (188) | (244) | (268) | (370) | *(1,212)* | *(1,072)* |
| Preferred dividends | (18) | (28) | (4) | (6) | (8) | (7) | (7) | *(28)* | *(28)* |
| Dividends (common & non-cont.) | (143) | (253) | (2) | (98) | (51) | (50) | (54) | *(199)* | *(207)* |
| **Gross free cash flow (FCF)** | **(495)** | **(620)** | **(94)** | **(88)** | **(143)** | **(160)** | **(222)** | ***(699)*** | ***(517)*** |
| Changes in working capital | (41) | 49 | (100) | 45 | 44 | (36) | (8) | - | - |
| Gross FCF after working capital | (536) | (571) | (194) | (43) | (99) | (196) | (230) | *(699)* | *(517)* |
| Other investing activities | (21) | 82 | (51) | 12 | 15 | 15 | 37 | - | - |
| **Free cash flow before financing** | **(557)** | **(489)** | **(245)** | **(31)** | **(84)** | **(181)** | **(193)** | ***(699)*** | ***(517)*** |
| Debt issuance/(repayment) | 551 | 146 | 214 | (226) | 45 | 155 | 172 | *320* | *247* |
| Issue of common shares | 46 | 80 | 14 | 23 | 16 | 19 | 22 | *70* | *70* |
| Issue of preference shares | - | 242 | - | 242 | - | - | - | *200* | *200* |
| Other financing activities | (5) | 45 | - | - | 1 | - | 44 | - | - |
| F/X gain/(loss) | (4) | - | (1) | (1) | 1 | - | - | - | - |
| **Net increase (decrease) in cash** | **31** | **24** | **(18)** | **7** | **(21)** | **(7)** | **45** | ***(109.0)*** | **-** |
| **Capital Structure** | | | | | | | | | |
| Total debt | 5,915 | 6,023 | 5,915 | 5,665 | 5,742 | 5,875 | 6,023 | *6,343* | *6,589* |
| Non-controlling interest | 123 | 162 | 123 | 118 | 125 | 122 | 162 | *162* | *162* |
| Preference Shares | 667 | 912 | 667 | 912 | 912 | 912 | 912 | *1,112* | *1,312* |
| Shareholders' equity | 3,193 | 3,305 | 3,193 | 3,212 | 3,248 | 3,255 | 3,305 | *3,566* | *3,835* |
| **Total capital** | **9,898** | **10,402** | **9,898** | **9,907** | **10,027** | **10,164** | **10,402** | **11,183** | **11,898** |
| Cash and equivalents | 85 | 109 | 85 | 92 | 71 | 64 | 109 | - | - |
| **Credit Ratios**[1] | | | | | | | | | |
| Total Debt / Capital | 63.1% | 62.3% | 63.1% | 61.8% | 61.8% | 62.3% | 62.3% | *61.7%* | *60.9%* |
| Net Debt / Capital | 62.8% | 61.9% | 62.8% | 61.4% | 61.5% | 62.0% | 61.9% | *61.7%* | *60.9%* |
| (FFO + interest) / interest | 2.9x | 3.1x | 2.9x | 2.9x | 2.9x | 2.9x | 3.1x | *3.1x* | *3.1x* |
| EBITDA / interest | 2.9x | 3.2x | 2.9x | 3.0x | 3.0x | 3.1x | 3.2x | *3.4x* | *3.4x* |
| EBIT / interest | 1.9x | 2.1x | 1.9x | 2.0x | 2.0x | 2.0x | 2.1x | *2.4x* | *2.4x* |
| Total Debt / EBITDA | 5.6x | 5.2x | 5.6x | 5.2x | 5.2x | 5.2x | 5.2x | *5.2* | *5.1* |
| FFO / Total Debt | 11.7% | 12.2% | 11.7% | 12.3% | 11.9% | 11.9% | 12.3% | *11.7%* | *12.0%* |

1. To calculate leverage ratios, we have attributed 50%/50% debt/equity treatment to Fortis Inc. preferred equity.

Source: Company reports, RBC Capital Markets estimates

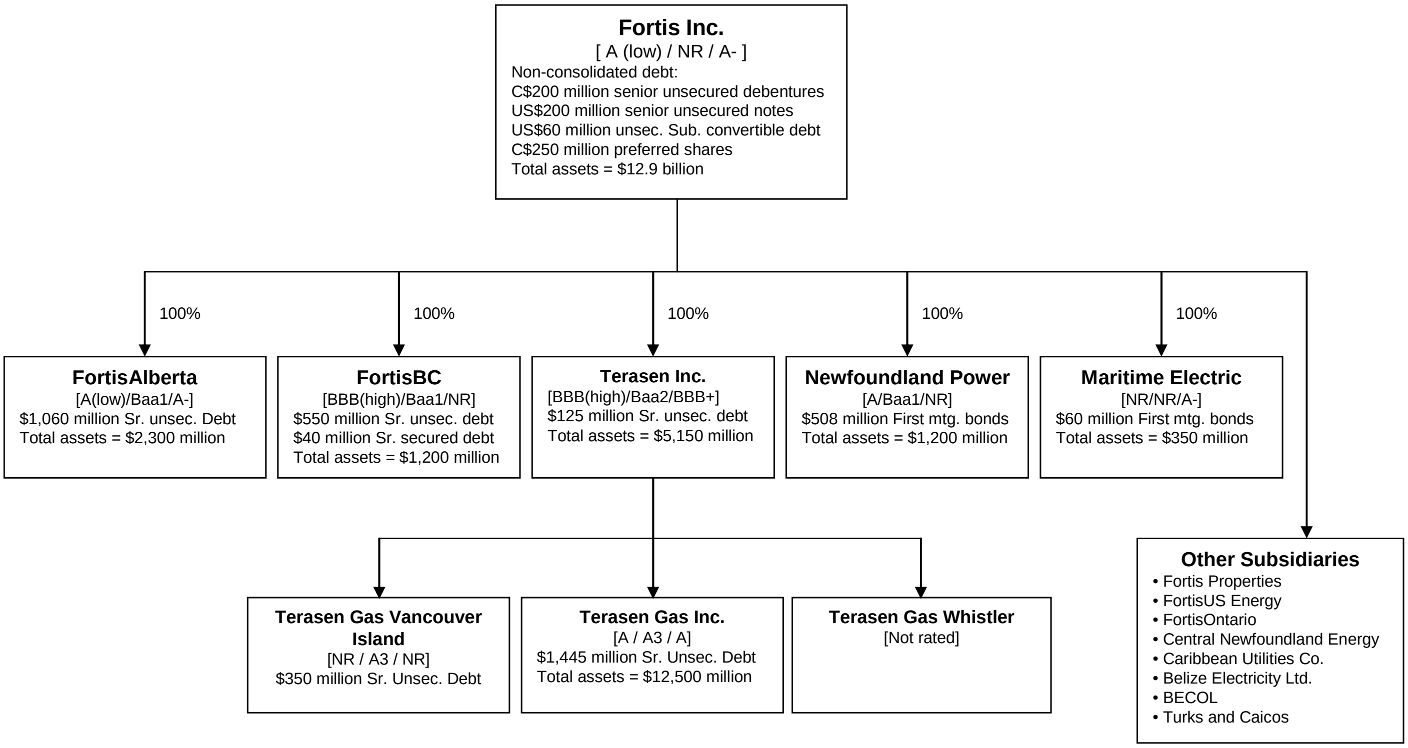
**Exhibit 6: Fortis Inc and Subsidiary Bonds Outstanding**

| Issuer Name | Amount ($ million) | Currency | Coupon | Maturity | Issue Date | Refund Type | Security |
|---|---|---|---|---|---|---|---|
| Fortis Inc.[1] | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc.[1] | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **400** | | | | | | |
| | | | | | | | |
| Terasen Inc. | 125 | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| | | | | | | | |
| Terasen Gas Vancouver | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Vancouver | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| **Total Terasen Gas Vancouver** | **350** | | | | | | |
| | | | | | | | |
| **Terasen Gas:** | | | | | | | |
| BC Gas Utility[2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc. | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Inc. | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | | |
| | | | | | | | |
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,060** | | | | | | |
| | | | | | | | |
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |
| | | | | | | | |
| Newfoundland Light & Power | 40 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | | |
| | | | | | | | |
| **Maritime Electric** | **60** | CAD | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| | | | | | | | |
| **Total Bonds Outstanding** | **4,538** | | | | | | |

(1) USD Private placements. (2) Terasen Gas was formerly called BC Gas Utility.

Source: Company reports, RBC Capital Markets Research

**Exhibit 7: Fortis Inc Organizational Structure**




Source: Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. Cash inflows from its subsidiaries are expected to exceed $190 million annually. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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RBC Capital Markets has provided Fortis Inc. with non-securities services in the past 12 months.

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**Top Pick (TP):** Represents the analyst’s best ideas in the Outperform category; provides best relative risk-reward ratio and/or is expected to significantly outperform the sector over 12 months.
**Outperform (O):** Provides superior relative risk-reward ratio and/or is expected to materially outperform the sector average over 12 months.

**Sector Perform (SP):** Provides an adequate relative risk-reward ratio and/or total return is expected to be in line with the sector average over 12 months.

**Underperform (U):** Provides an inferior relative risk-reward ratio and/or total return is expected to be materially below the sector average over 12 months.

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Distribution of Ratings
RBC Capital Markets, Credit Research

| | | | Investment Banking Serv./Past 12 Mos. | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| BUY[TP/O] | 66 | 34.20 | 29 | 43.94 |
| HOLD[SP] | 93 | 48.19 | 57 | 61.29 |
| SELL[U] | 34 | 17.62 | 21 | 61.76 |

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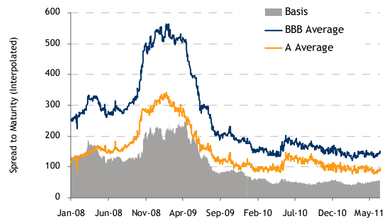
**Volume 22**
June 17, 2011

# Credit Weekly

## Fortis Expands South of the Border

**Corporate Spread Differentials (10yr)**




Source: ADI, RBC Capital Markets

Fortis completed its equity offering this week, lifting our research restriction.

We view the recently announced Central Vermont Public Service (CVPS) acquisition by Fortis as generally positive for credit given: (1) the added diversification from a stable regulated utility; (2) smaller than expected size; and (3) supportive funding strategy. The US$700MM (including US$230MM of debt) acquisition is expected to close in the next six to 12 months.

**Stable regulated utility adds diversification:** In our view, Fortis' business profile will improve with the addition of a stable regulated utility like CVPS. CVPS will also provide a solid building block for future acquisitions as it is fairly close to Forts' existing Central and Eastern Canadian operations. Moreover, these assets are strategically located near other utilities that are currently owned by larger European-based companies that may decide to sell in the future.

**Smaller than expected size:** With the exception of the size, the acquisition was in-line with management's goal of adding a regulated electric utility with single state regulation, and good prospects for rate base growth. CVPS' enterprise value of US$700MM was much lower than the US$3-US$5B target that Fortis had been guiding towards over the past couple years. We believe the smaller than expected size is more supportive for credit as it puts less pressure on the company's balance sheet, should be more manageable to integrate, and allows Fortis time to become familiar with the state regulation.

**Acquisition expected to be funded in-line with current capital structure:** We expect Fortis will ultimately fund the CVPS acquisition in a manner similar to past utility acquisitions, namely with a mix of common and preferred equity as well as debt that will maintain the company's consolidated capital structure close to 60%/40% (debt/equity). With the transaction not expected to close for at least six to 12 months, Fortis' recent equity offering ($300MM before over-allotment) provides the company with cash to inject equity into its utility subsidiaries and fund other growth projects like the Waneta Hydroelectric Plant. Management intends to finance the equity portion ($280MM) of the CVPS acquisition with preferred shares closer to the time of offering (depending on market conditions at the time), which would leave about $190MM of incremental new debt required at Fortis. With this funding plan as a basis, our forecasts out to 2012 indicate Fortis' credit profile will remain largely unchanged.

**Fortis Inc. bonds offer favourable yield pick-up over Opco bonds:** For investors seeking additional yield in the utility space, we continue to like the favourable spread pick up of 20-25bps offered by Fortis HoldCo bonds versus its Opco bonds. In our view, the structural subordination on the Holdco bonds is largely offset by the diversified and stable source of cash flows generated by Fortis' utility subsidiaries – which in our view should improve with the acquisition of CVPS.

**CVPS / Acquisition overview:** With close to 160,000 customers, CVPS is the largest integrated electric utility in Vermont. Its service territory covers about two-thirds of Vermont, with current energy supply coming from nuclear (50%), hydro (40%) and other (10%). Also, through its 41% interest in Vermont Transco, CVPS owns and operates a high-voltage electric transmission system. CVPS' ROE for 2011 is 9.45%, which is largely in-line with Fortis' existing utilities, while CVPS' equity thickness of 57% is much higher than Fortis' Canadian regulated utilities (40-45% range). CVPS' rate base of US$426MM in 2010 is forecasted to grow at 9% CAGR until 2015, higher than the estimated 6% for Fortis' other utilities. The $700MM acquisition cost represents about 1.4x the 2011 mid-year rate base (adjusted for debt at Vermont Transco). Using the forward P/E valuation of 21x (using the mid-point of CVPS' 2011 EPS guidance) reflects full value for the company.

**Matthew Kolodzie**

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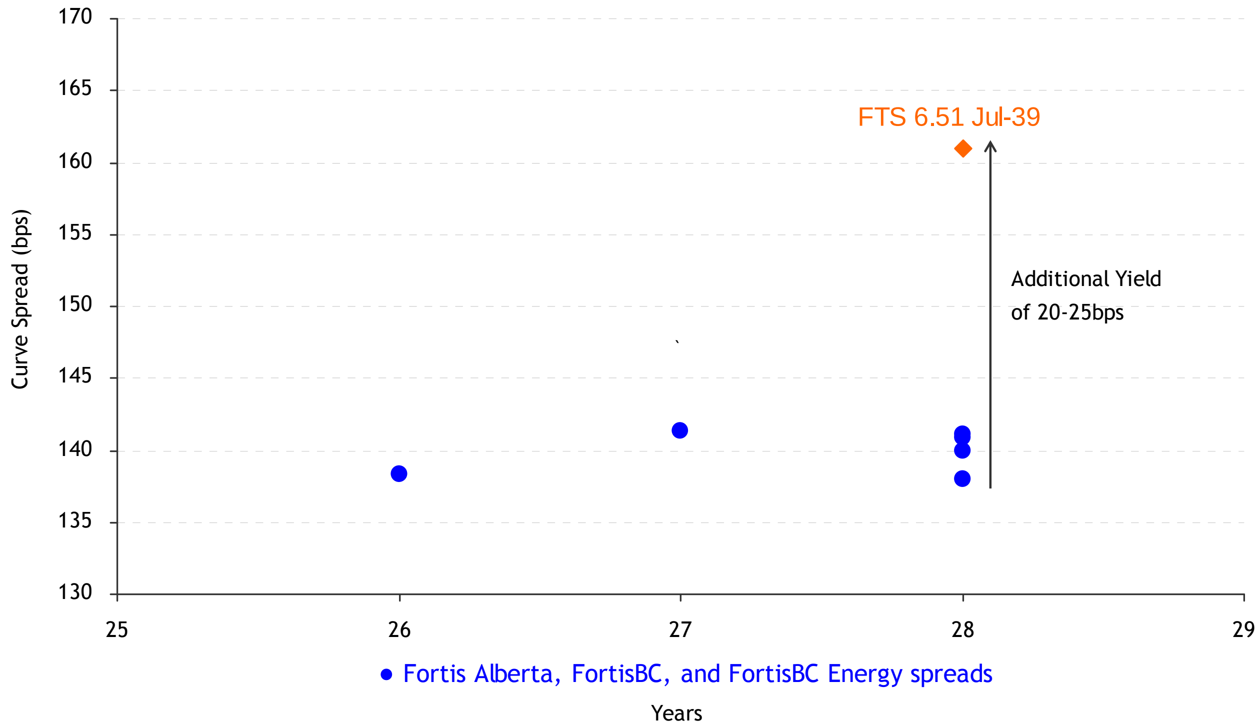
**Exhibit 1: Relative Value Chart – Fortis HoldCo vs. OpCo Spreads**




Source: Bloomberg, RBC Capital Markets

# Calendar of Events

| June 2011 | | | | |
|---|---|---|---|---|
| **Monday 20** | **Tuesday 21** | **Wednesday 22** | **Thursday 23** | **Friday 24** |
| | | | | |
| | | | | **July 2011** |
| **Monday 27** | **Tuesday 28** | **Wednesday 29** | **Thursday 30** | **Friday 1** |
| | | Shaw Comm. Q3 | Empire Co. (Sobeys) Q4 | |
| **Monday 4** | **Tuesday 5** | **Wednesday 6** | **Thursday 7** | **Friday 8** |
| | | | Cogeco Cable Q3 | |
| **Monday 11** | **Tuesday 12** | **Wednesday 13** | **Thursday 14** | **Friday 15** |
| | | | Corus Q3<br>JP Morgan Q2 | Nexen Q2<br>Citigroup Q2 |
| **Monday 18** | **Tuesday 19** | **Wednesday 20** | **Thursday 21** | **Friday 22** |
| | | Goldman Sachs Q2 | Encana Q2<br>Wells Fargo Q2<br>Morgan Stanley Q2 | Loblaw Q2<br>Shoppers Drug Mart Q2<br>Ford Q2<br>General Electric Q2 |
| **Monday 25** | **Tuesday 26** | **Wednesday 27** | **Thursday 28** | **Friday 29** |
| | Rogers Comm. Q2<br>Cenovus Q2 | Capital Power Inc. LP Q2<br>Enbridge Income Fund Q2<br>Talisman Energy Q2 | Bell Aliant Q2<br>Sherritt Q2<br>Enbridge Q2<br>Husky Energy Q2<br>Suncor Energy Q2<br>Enbridge Energy Partners Q2<br>Sun Life Q2 | George Weston Q2<br>Honda Q1<br>Thomson Reuters Q2<br>Genworth Q2<br>Fairfax Finl. Q2<br>AltaGas Q2<br>Canadian Oil Sands Q2<br>Canadian Utilities Ltd Q2<br>TransAlta Q2<br>TransCanada Q2 |

Source: Bloomberg, RBC Capital Markets

# New Issuance Activity (June 10 – June 16)

| Issuer | Issued (MM) | Coupon (%) | Maturity | Ratings (DBRS/MDY/S&P) | Spread | Benchmark | Announced |
|---|---|---|---|---|---|---|---|
| Sydney Airport Finance | CAD 225 | 4.602 | 27-Jul-18 | - / Baa2 / BBB | n/a | n/a | 14-Jun-11 |
| Canadian Satellite Radio | CAD 62 | 9.75 | 21-Jun-18 | - / - / - | 708.1bps | CAN 4.25 1JUN18 | 14-Jun-11 |
| Canexus Income Fund | CAD 60 | 5.75 | 31-Dec-18 | - / - / - | n/a | n/a | 15-Jun-11 |
| South Coast BC Trans. Authority | CAD 200 | 4.65 | 20-Jun-41 | AA / Aa2 / - | 117bps | CAN 4 1JUN41 | 15-Jun-11 |
| Union Gas Ltd. | CAD 300 | 4.88 | 21-Jun-41 | Ae / - / - | 147bps | CAN 4 1JUN41 | 16-Jun-11 |
| Bank of Nova Scotia | CAD 200 | FRN | 21-Dec-12 | AAe / Aa1e / - | 25bps | 1M CDOR | 16-Jun-11 |
| Videotron Ltee | CAD 300 | 6.875 | 15-Jul-21 | BBHe / Ba1e / - | 395.2bps | CAN 3.25 6/21 | 16-Jun-11 |

Source: Bloomberg, RBC Capital Markets

# Rating Actions (June 10 – June 16)

| Rating Agencies | Agency | Rating Action | Rating Type | To | From | Date |
|---|---|---|---|---|---|---|
| Armtec Holdings Ltd. | DBRS | Under Review | Senior Unsecured Debt | BB *- | BB | 10-Jun-11 |
| Armtec Holdings Ltd. | DBRS | Under Review | LT Issuer Rating | BBL *- | BBL | 10-Jun-11 |
| Armtec Holdings Ltd. | S&P | Downgraded / UR. | LT Local Issuer Credit | B+ *- | BB- | 13-Jun-11 |
| Capstone Infrastructure Corp. | S&P | Announcement | LT Local Issuer Credit | BBB-/Stable | NR | 13-Jun-11 |
| OPTI Canada Inc. | S&P | Downgraded | LT Local Issuer Credit | SD[1] | CCC- | 16-Jun-11 |

*- Under Review with Negative Implications

1. Selective default

Source: Bloomberg, RBC Capital Markets

# Market Commentary

**Corporate Bonds (S. Thom):** A very whippy week that started off with a soft tone, offered a glimmer of hope thereafter due to some less-downbeat economic data, proceeded to tumble on renewed Greek debt concerns and is ending on an upbeat note. For all the yo-yo like action in the market, the IG looks to be ending the week largely unchanged from where we started, out 0.5bps to 99.7 as of this morning (having closed in a range of 96.5-100.4 during the week). Looking at specific areas, Deposit Notes ended largely unchanged; new generation bank sub-debt was out 1-4bps with old generation out less so, similar story for bank hybrids – with par-call out more than non-par-call; Lifeco paper was whippy, with buyers emerging on widening (the sector still represents interesting value in our view); telcos were better offered (particular pressure on Shaw in the belly at one stage); airports were active in the belly on the Sydney Airport Finance Co. deal (see new issue summary); investors were extending in infrastructure and utilities (which continue to look expensive); and Maple banks / brokers remain under pressure with the ongoing regulatory noise.

**HY Commentary (O. von Richter)**: The week began on a quiet note as heightened volatility and a weak market backdrop sent most investors to the safety of the sidelines. The light flow that we did see was better buying with a preference for higher rated credits. Later in the week as tone improved Videotron tapped the market with a C$300mm 10NC5 transaction that priced at par with a coupon of 6.875%. The bonds traded up in very active 2-way secondary trade and are closing the week $100.5-101.5. Next week, RBCCM is hosting its annual C$ High Yield Conference in Toronto. Next Tuesday SkyLink Aviation is holding its Q1 earnings call at 2pm.

**ABS/CMBS (L. McKean):** An active week in the asset-backed space as secondary volumes were good and a new Auto deal was brought to market. Spreads are generally ending the week 3-5bps wider in the front-end and 1-2bps in the 5-year area – as the 5-year space continues to benefit from strong client interest. The catalyst for the move in spreads was heightened global market volatility (read, Greece) and the wider spread levels did generate client interest – so we'd characterize activity as better buying. At the end of the week Canadian Capital Auto Receivables Asset Trust II (CCARAT) brought a $541MM 3-tranche deal to market. CCARAT 2011-2 is a securitization of new and used auto loans (retail car and light truck), both subvented and non-subvented.

**Swaps (R. Nambiar):** A rollercoaster of a week as uncertainties in Greece continues to leave the market on edge driving significant risk-on/risk-off swings in the market. Over the week, Canadian swap spreads are ~1 bps wider in the belly and ~1 to 2 bps tighter in the wings.

Tuesday, stronger than expected US PPI and Retail Sales drove a sell-off in bonds. However, early Wednesday, Moody's placed France's three largest banks under review citing the banks' exposures to Greek debt as the main catalyst, driving a risk-off move. Then concerns that the Greece government would fall apart and that the Prime Minister would resign reversed Tuesday's move. Lost in the news was a hawkish statement from Carney which had no impact on the market as global stability would have to resume before the BoC is expected to take tightening action.

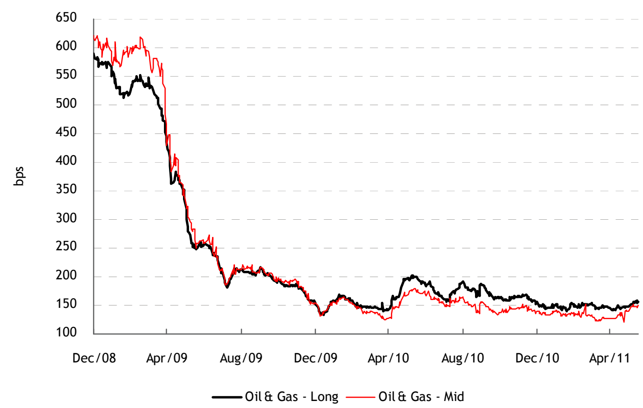
Over the week Canadian swap spreads saw strong paying in the belly as levels to pay Canada versus the US improved. In addition, the market saw paying from asset swappers, mortgage book paying and rate receiving form a variety of investors. As we reach attractive paying levels, we expect to see more natural payers and market speculators paying spreads.

Of note, Canada saw a 2-year auction and subsequent roll of the benchmark bond. GoCs are ending the week ~2 to 7 bps tighter across the curve led by the belly and long end.

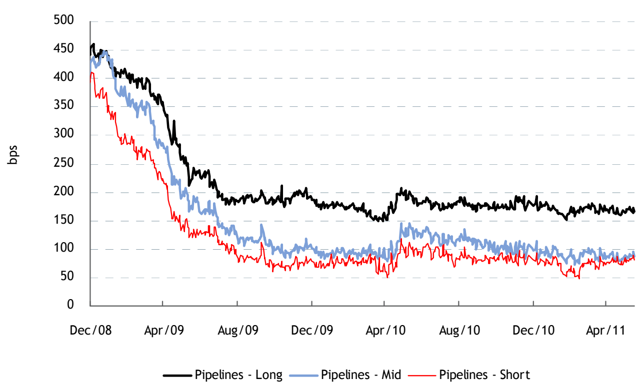
# Spread Indices by Sector

### Infrastructure

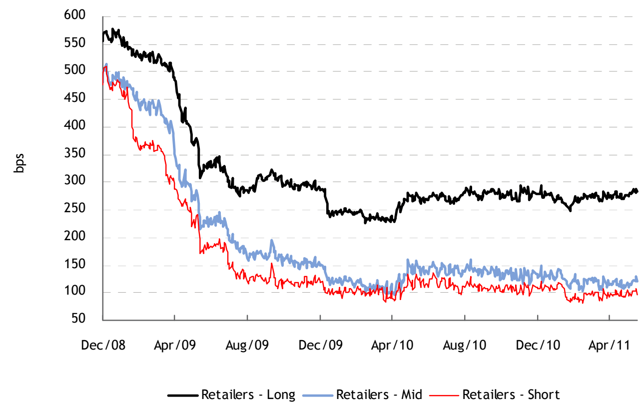

### Oil & Gas



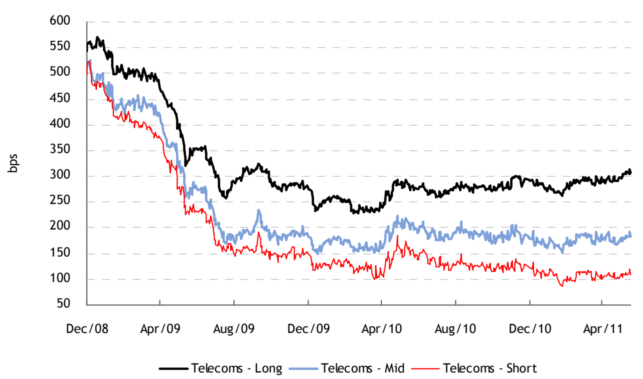

### Pipelines



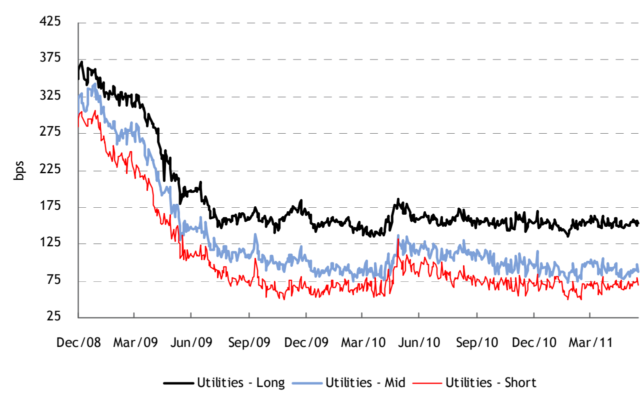

### Retailers




### Telecom

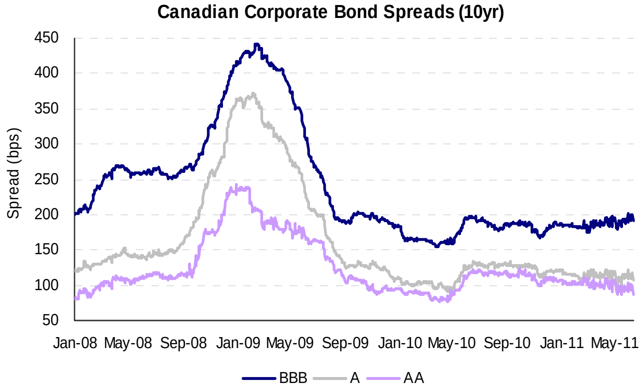


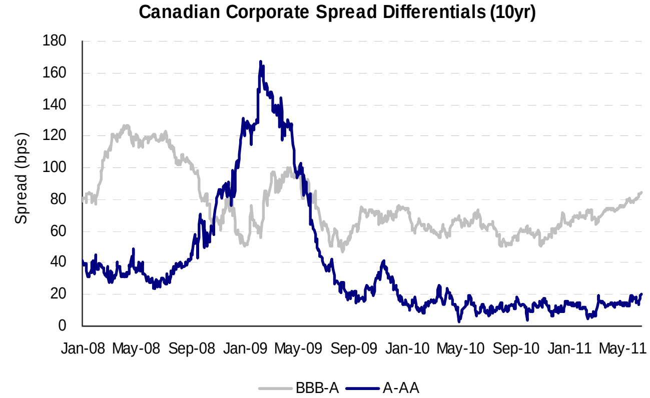

### Utilities

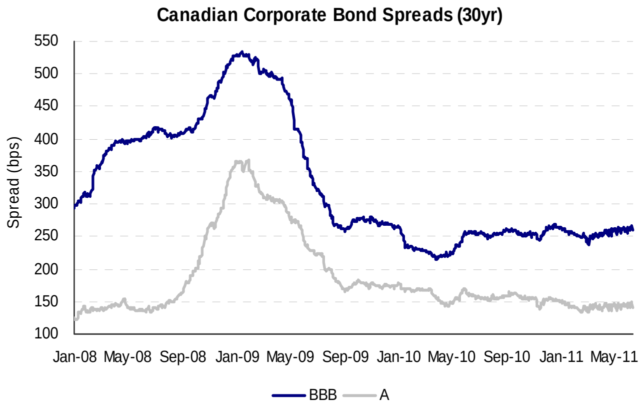


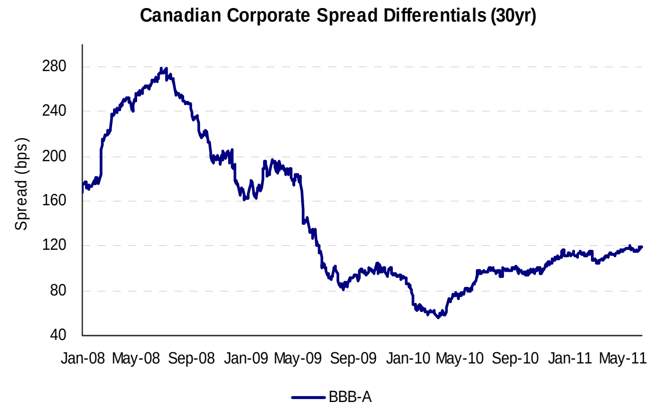

Source: Advantage Data Inc, RBC Capital Markets

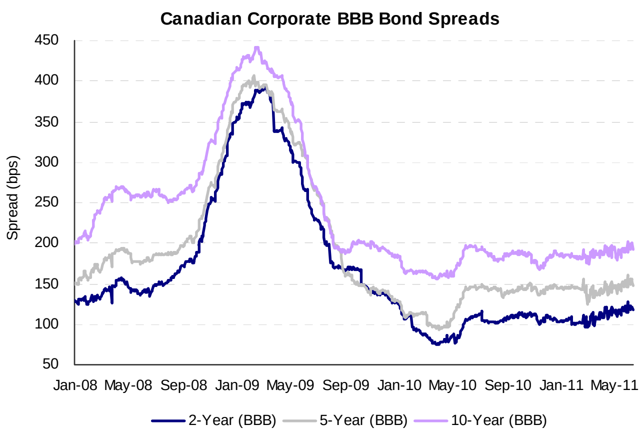
# Spread Indices by Rating

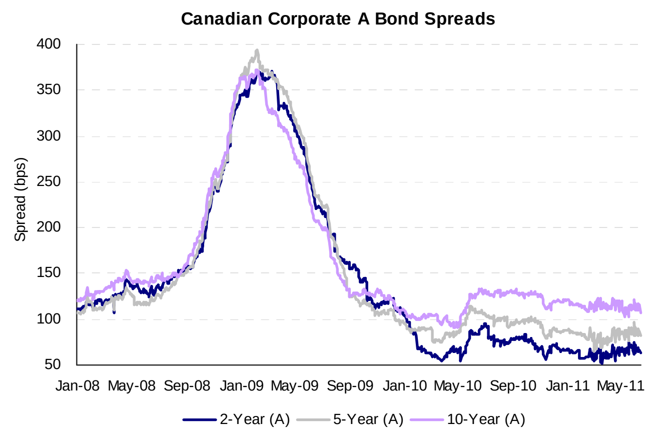



Source: Bloomberg, RBC Capital Markets

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The rating assigned to a security of a subject company in an analyst's 'sector' represents the analyst's view of how that security will perform over the next 12 months relative to all similar securities, issued by other subject companies in the analyst's sector. An analyst's 'sector' is the universe of subject companies in a particular industry for which the analyst provides research coverage. Different securities of a subject company may have different ratings, depending on the currency in which a security is denominated and/or the security's position in the subject company's capital structure.

**Top Pick (TP):** Represents the analyst's best ideas in the Outperform category; provides best relative risk-reward ratio and/or is expected to significantly outperform the sector over 12 months.

**Outperform (O):** Provides superior relative risk-reward ratio and/or is expected to materially outperform the sector average over 12 months.

**Sector Perform (SP):** Provides an adequate relative risk-reward ratio and/or total return is expected to be in line with the sector average over 12 months.

**Underperform (U):** Provides an inferior relative risk-reward ratio and/or total return is expected to be materially below the sector average over 12 months.

## Distribution of Ratings

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**Distribution of Ratings**
**RBC Capital Markets, Credit Research**

| Rating | Count | Percent | Investment Banking Serv./Past 12 Mos. Count | Percent |
|---|---|---|---|---|
| BUY[TP/O] | 107 | 33.65 | 63 | 58.88 |
| HOLD[SP] | 147 | 46.23 | 98 | 66.67 |
| SELL[U] | 64 | 20.13 | 30 | 46.88 |

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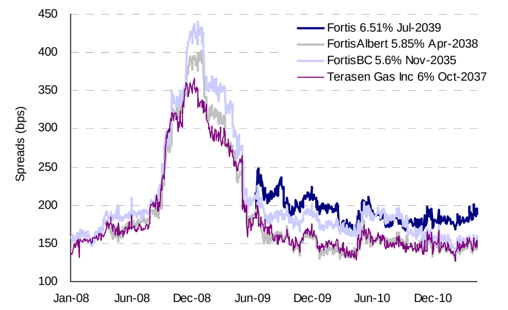
MAY 5, 2011

# Fortis Inc.

## Q1/11: Utilities in the West Provide a Boost

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta Inc.** | **Sector Perform** |
| **FortisBC Inc.** | **Outperform** |
| **FortisBC Energy Inc.** | **Sector Perform** |
| **FortisBC Energy (Van.Island) Inc.** | **Outperform** |
| **Newfoundland Power Inc.** | **Sector Perform** |

**Fortis Inc Historical Spreads**




Source: ADI, RBC Capital Markets Research

| Cash Flow Summary ($MM) | 2009 | 2010 | *2011E* | *2012E* |
|---|---|---|---|---|
| EBITDA | 1,065 | 1,150 | *1,231* | *1,304* |
| **FFO** | **690** | **734** | *740* | *790* |
| Capital expenditures | (1,024) | (1,073) | *(1,212)* | *(1,072)* |
| Dividends | (161) | (281) | *(227)* | *(235)* |
| **Gross FCF** | **(495)** | **(620)** | *(699)* | *(517)* |
| Changes in w/c | (41) | 49 | - | - |
| FCF after w/c | (536) | (571) | *(699)* | *(517)* |
| Other investing | (21) | 82 | - | - |
| **FCF before financing** | **(557)** | **(489)** | *(699)* | *(517)* |
| Debt issuance/(repay.) | 551 | 146 | *320* | *247* |
| Common issuance | 46 | 80 | *70* | *70* |
| Preferred issuance | - | 242 | *200* | *200* |
| Other financing | (9) | 45 | - | - |
| **Net change in cash** | **31** | **24** | *(109)* | - |
| **Capital Structure** | | | | |
| Total debt | 5,915 | 6,023 | *6,343* | *6,589* |
| Non-controlling int. | 123 | 162 | *162* | *162* |
| Preference Shares | 667 | 912 | *1,112* | *1,312* |
| Shareholders' equity | 3,193 | 3,305 | *3,566* | *3,835* |
| **Total capital** | **9,898** | **10,402** | *11,183* | *11,898* |
| Cash and equivalents | 85 | 109 | - | - |
| **Credit Ratios** | | | | |
| Total Debt / Capital[1] | 63% | 62% | *62%* | *61%* |
| Net Debt / Capital[1] | 63% | 62% | *62%* | *61%* |
| EBITDA / interest | 2.9x | 3.2x | *3.4x* | *3.4x* |
| EBIT / interest | 1.9x | 2.0x | *2.4x* | *2.4x* |
| Total Debt / EBITDA | 5.6x | 5.2x | *5.2x* | *5.1x* |
| FFO / Total Debt | 11.7% | 12.2% | *11.7%* | *12.0%* |
| **Credit Ratios** | | **DBRS** | **S&P** | ***Moody's*** |
| Rating | | A(L) | A- | NR |
| Outlook | | Stable | Stable | - |

1. 50% equity and 50% debt treatment to pref. shares

Source: RBC Capital Markets estimates, Company reports, Rating agencies

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All values in Canadian dollar unless otherwise noted.

**Fortis reports Q1/11 (credit neutral):** Fortis reported Q1/11 EPS of $0.67 versus RBC and consensus estimates of $0.63 and $0.62. FFO for the quarter was $242MM higher than $204MM in Q1/10, and credit metrics showed modest improvement sequentially with total debt-to-capital and FFO-to-interest of 57% and 3.1x, respectively (Exhibit 2). The cash flow and earnings improvement was mainly driven by FortisAlberta and FortisBC from rate base growth and higher regulated rates.

**Gross FCF shortfall funded with favourable change in WC:** Fortis generated a Gross FCF deficit of $51MM after accounting for capex ($233MM) and dividends ($60MM). The gap was funded primarily with a favourable swing in WC of $57MM during the quarter.

**Capex of $5.5 billion over five years:** Capex in 2010 hit a record $1.1B, and is expected to reach $1.2B in 2011. Fortis expects its capex program to reach $5.5B over the next five years, the majority of which will be at its regulated Canadian utilities. In addition, Fortis remains on the hunt for a utility acquisition in the U.S. with an enterprise value of $1.0B to $5.0B.

**Less capital markets activity expected this year than last:** Our forecasts indicate FortisAlberta and FortisBC Energy ("FBCE") could tap the debt markets later this year for $200MM and $100MM, respectively. We think Fortis Inc. may need to issue up to $200MM in preferred shares in order to fund equity injections into its operating company and maintain credit metrics. This compares to last years where Fortis and its subsidiaries issued $525MM in debt in 5 tranches, and Fortis Inc. issued of $250MM in preferred shares.

**Merging the BC gas utilities:** Fortis intends to file an application with the BCUC this year to amalgamate its three B.C.-based gas utilities. If approved, the three utilities would form one legal entity and bonds issued by FBCE and FortisBC Energy (Vancouver Island) Inc. ("FBCV") would rank parri passu. Our Outperform ranking on FBCV is based on the view that spreads on FBCV bonds would tighten to trade in line with FBCE bonds after the amalgamation.

**Holdco bonds offer favourable pick-up:** We think the discount that Fortis Inc. "holdco" bonds trade at, relative to the company's regulated utility opco's, provides a favourable spread pick-up (30 to 35 bps) to compensate for the structural subordination, especially when considering the diversified and stable source of cash flow generated by its utility subsidiaries. We highlight the key risk in holding Fortis Inc. bonds is the potential for a sizable U.S. utility acquisition that would result in the issuance of a material amount of holdco debt. However, based on past acquisitions by Fortis Inc., we expect such a transaction to involve sufficient equity to maintain existing credit ratings.

**FortisBC bonds still offer good value:** FortisBC outperformed the regulated utility peer group in 2010. While the discount offered by FortisBC bonds is not as favourable as in the past, we continue to like these bonds given there is still a 5bps pick-up to most regulated utility peers.



**For Required Conflicts Disclosures, please see Page 8.**

## Highlights, continued:

**Rates for 2011:** Customer rates have been set, effective January 1, 2011 at Fortis' four largest utilities, with allowed ROE's unchanged at FortisBC Energy (9.5% on deemed equity of 40%), FortisBC (9.9% on deemed equity of 40%) and FortisAlberta (9.0% on deemed equity of 41% - interim pending finalization by the AUC). Newfoundland Power's ROE has decreased to 8.38% +/-50bps on a deemed equity of 45% for 2011 (from 9.0% in 2010), based on the utility's automatic-adjustment formula.

**Adequate liquidity: Adequate liquidity:** At the end of Q1/11, Fortis Inc and its subsidiaries had $1.5B available under its $2.1B credit facilities. The company also had $86MM in cash and equivalents. We believe this is adequate to meet the company's near-term requirements.

## Outlook and Funding Expectations

**$5.5 billion of capital spending over five years:** Management confirmed the $1.2B capex guidance for 2011 provided earlier in the year. Approximately 63% will be spent on regulated electric utilities, the bulk of which will be at FortisAlberta and Fortis BC Electric, while regulated gas utilities and non-regulated operations (including the $900MM Waneta hydroelectric expansion project in British Columbia – expected to be completed in 2015) will receive 20% and 17%, respectively. Fortis is expecting to maintain record investment over the next five years, with forecasted spending of $5.5B during this period. We note the $1.1B spent in 2010 was a record for the company.

**Utility acquisitions a continued focus:** Management continues to look to acquire utility (gas and/or electric utilities or integrated including generation) assets with a size of $1 billion to $5 billion in enterprise value. Management had indicated that it came close to a transaction in 2010, but lost out to a higher bidder. The company has stated that an acquisition would have to be EPS accretive in the first year. Geographies of focus are in Canada and the U.S. We expect any material acquisition would be funded with a mix of debt and sufficient equity (common and preferreds) to maintain current credit ratings, based on how Fortis has handled large transactions in the past (such as Terasen Gas, and FortisAlberta and FortisBC).

**Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. Fortis and its subsidiaries do not have any bond maturities in 2011 (Exhibit 5), so any new issuance this year will be to fund capex. For a detailed look at each of the issuing entities, please refer to our report titled, "Utilities in Canada: Credit Outlook 2011" published April 7, 2011:

- **Fortis Inc.:** For 2011, we are forecasting that at the holdco level, Fortis Inc. will need to issue roughly $200MM in preferred shares in 2011 in order to maintain balance sheet leverage near current levels and fund corporate level activities. We expect borrowing at the holdco level to be minimal. In 2010, Fortis Inc. accessed the capital markets twice: (i) $250MM in cumulative redeemable preference shares (January); and (ii) a US$200MM private placement.
- **FortisBC Energy:** For 2011, we are forecasting a modest gross FCF shortfall of about $65MM, which is in line with 2010. We think this shortfall will most likely be funded with the company's credit facilities but could be termed out with a public debt issuance of $100MM later this year. In 2010, FBCE received an equity injection of $125MM from Fortis Inc. in Q1/10 to boost Terasen Gas' deemed equity base to 40% (from 35%) in response to a recent regulatory decision, and FBCV issued $100MM in debt.
- **FortisAlberta:** We are forecasting that FortisAlberta will need $150MM to $200MM in debt, plus a $60MM equity injection from Fortis, to fund its $420MM capital program in 2011. In 2010, FortisAlberta issued $125MM in debt and had received $55MM in equity contributions from Fortis Inc.
- **FortisBC:** We are forecasting FortisBC to draw approximately $30MM on its short-term credit facilities, and will not require an equity injection from Fortis, to fund its $99M capital program in 2011. In 2010, FortisBC issued $100MM in debt and received a $10MM equity contribution from Fortis Inc.
- **Newfoundland Power:** We expect Newfoundland Power to fund its 2011 capital program with cash flow and proceeds from the $46MM sale of joint-use poles to Bell Aliant.

**Exhibit 1: Capital Spending by Subsidiary ($ millions)**

| | FortisBC Energy Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| 2011F | 281 | 420 | 99 | 73 | 46 | **919** | 83 | 183 | 27 | **1,212** |
| 2010A | 253 | 379 | 139 | 78 | 48 | **897** | 72 | 85 | 19 | **1,073** |

Source: Company reports

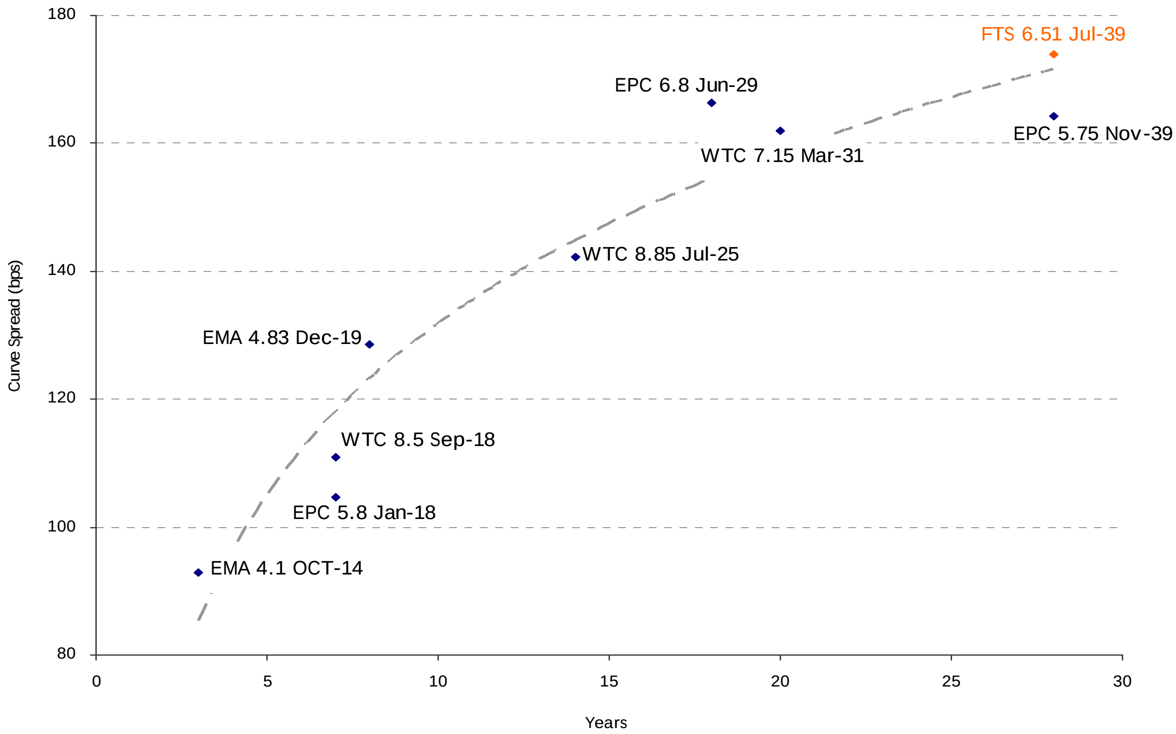
## Exhibit 2: Fortis Inc. Historical Consolidated Financials and Forecasts

| Fortis Inc ($million) | Annual | | Quarterly | | | | | Forecasts | |
|---|---|---|---|---|---|---|---|---|---|
| **Earnings Summary** | **2009** | **2010** | **Q1/10** | **Q2/10** | **Q3/10** | **Q4/10** | **Q1/11** | *2011E* | *2012E* |
| EBITDA | 1,065 | 1,150 | 322 | 267 | 265 | 301 | 348 | *1,231* | *1,304* |
| EBIT | 701 | 740 | 225 | 169 | 148 | 198 | 245 | *880* | *919* |
| Gross interest | 362 | 361 | 90 | 89 | 92 | 90 | 94 | *360* | *379* |
| Net income (as reported) | 280 | 313 | 106 | 63 | 52 | 92 | 124 | *390* | *405* |
| **Cash Flow Summary** | | | | | | | | | |
| **FFO** | 690 | 734 | 204 | 160 | 165 | 209 | 242 | *740* | *790* |
| Capital Expenditures | (1,024) | (1,073) | (188) | (244) | (268) | (370) | (233) | *(1,212)* | *(1,072)* |
| Preferred dividiends | (18) | (28) | (6) | (8) | (7) | (7) | (7) | *(28)* | *(28)* |
| Dividends (common & non-cont.) | (143) | (253) | (98) | (51) | (50) | (54) | (53) | *(199)* | *(207)* |
| **Gross free cash flow (FCF)** | **(495)** | **(620)** | **(88)** | **(143)** | **(160)** | **(222)** | **(51)** | *(699)* | *(517)* |
| Changes in working capital | (41) | 49 | 45 | 44 | (36) | (8) | 57 | - | - |
| Gross FCF after working capital | (536) | (571) | (43) | (99) | (196) | (230) | 6 | *(699)* | *(517)* |
| Other investing activities | (21) | 82 | 12 | 15 | 15 | 37 | 14 | - | - |
| **Free cash flow before financing** | **(557)** | **(489)** | **(31)** | **(84)** | **(181)** | **(193)** | **20** | *(699)* | *(517)* |
| Debt issuance/(repayment) | 551 | 146 | (226) | 45 | 155 | 172 | (87) | *320* | *247* |
| Issue of common shares | 46 | 80 | 23 | 16 | 19 | 22 | 27 | *70* | *70* |
| Issue of preference shares | - | 242 | 242 | - | - | - | - | *200* | *200* |
| Other financing activities | (5) | 45 | - | 1 | - | 44 | 17 | - | - |
| F/X gain/(loss) | (4) | - | (1) | 1 | - | - | - | - | - |
| **Net increase (decrease) in cash** | **31** | **24** | **7** | **(21)** | **(7)** | **45** | **(23)** | *(109)* | - |
| **Capital Structure** | | | | | | | | | |
| Total debt | 5,915 | 6,023 | 5,665 | 5,742 | 5,875 | 6,023 | 5,915 | *6,343* | *6,589* |
| Non-controlling interest | 123 | 162 | 118 | 125 | 122 | 162 | 175 | *162* | *162* |
| Preference Shares | 667 | 912 | 912 | 912 | 912 | 912 | 912 | *1,112* | *1,312* |
| Shareholders' equity | 3,193 | 3,305 | 3,212 | 3,248 | 3,255 | 3,305 | 3,397 | *3,566* | *3,835* |
| **Total capital** | **9,898** | **10,402** | **9,907** | **10,027** | **10,164** | **10,402** | **10,399** | **11,183** | **11,898** |
| Cash and equivalents | 85 | 109 | 92 | 71 | 64 | 109 | 86 | - | - |
| **Credit Ratios[1]** | | | | | | | | | |
| Total Debt / Capital | 59.8% | 57.9% | 57.2% | 57.3% | 57.8% | 57.9% | 56.9% | 56.7% | 55.4% |
| Total Debt / Capital[1] | 63.1% | 62.3% | 61.8% | 61.8% | 62.3% | 62.3% | 61.3% | *61.7%* | *60.9%* |
| Net Debt / Capital | 59.4% | 57.5% | 56.8% | 57.0% | 57.5% | 57.5% | 56.5% | 56.7% | 55.4% |
| Net Debt / Capital[1] | 62.8% | 61.9% | 61.4% | 61.5% | 62.0% | 61.9% | 60.9% | *61.7%* | *60.9%* |
| (FFO + interest) / interest | 2.9x | 3.0x | 2.9x | 2.9x | 2.9x | 3.0x | 3.1x | *3.1x* | *3.1x* |
| EBITDA / interest | 2.9x | 3.2x | 3.0x | 3.0x | 3.1x | 3.2x | 3.2x | *3.4x* | *3.4x* |
| EBIT / interest | 1.9x | 2.0x | 2.0x | 2.0x | 2.0x | 2.0x | 2.1x | *2.4x* | *2.4x* |
| Total Debt / EBITDA | 5.6x | 5.2x | 5.2x | 5.2x | 5.2x | 5.2x | 5.0x | *5.2* | *5.1* |
| FFO / Total Debt | 11.7% | 12.2% | 12.3% | 11.9% | 11.9% | 12.3% | 13.1% | *11.7%* | *12.0%* |

1. To calculate adjusted leverage ratios, we have attributed 50%/50% debt/equity treatment to Fortis Inc. preferred equity.

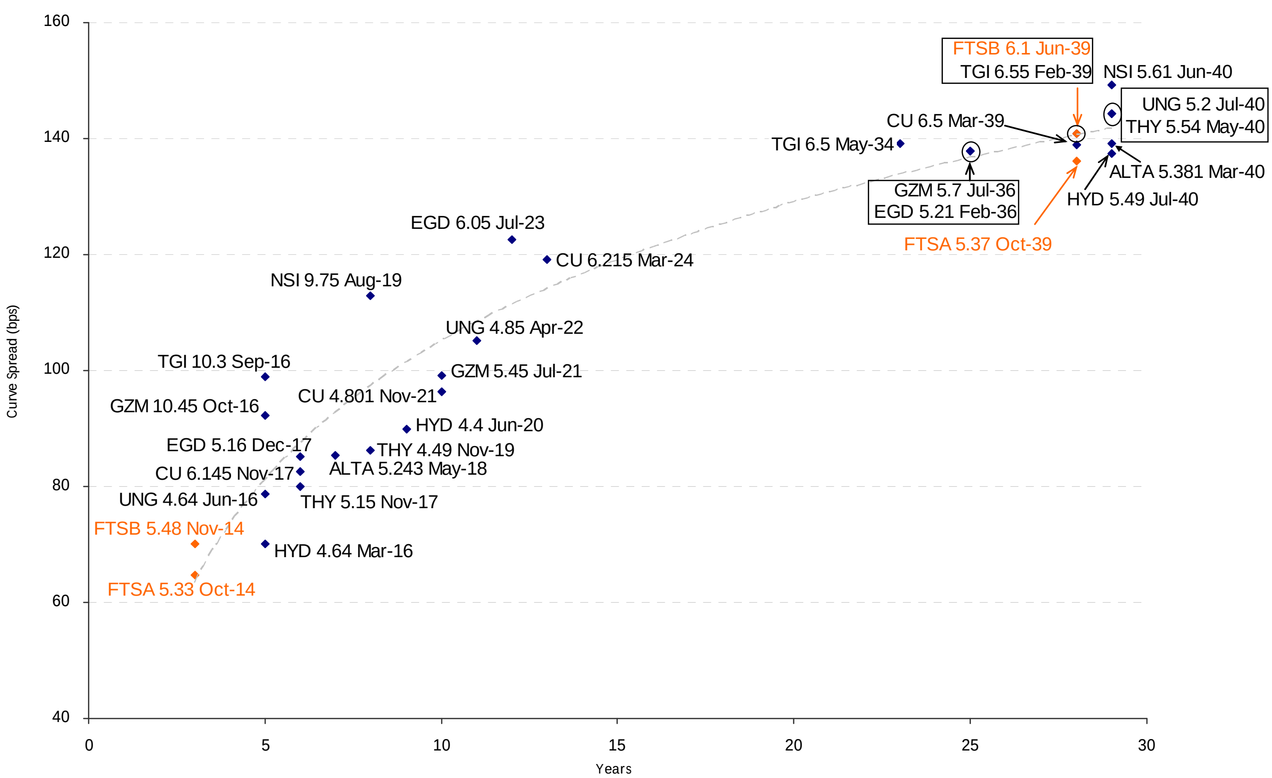
Source: Company reports, RBC Capital Markets estimates

### Exhibit 3: Relative Value Chart - Canadian Utility Holding Companies




Source: RBC Capital Markets Research

### Exhibit 4: Relative Value Chart - Canadian Regulated Utilities




Source: RBC Capital Markets Research

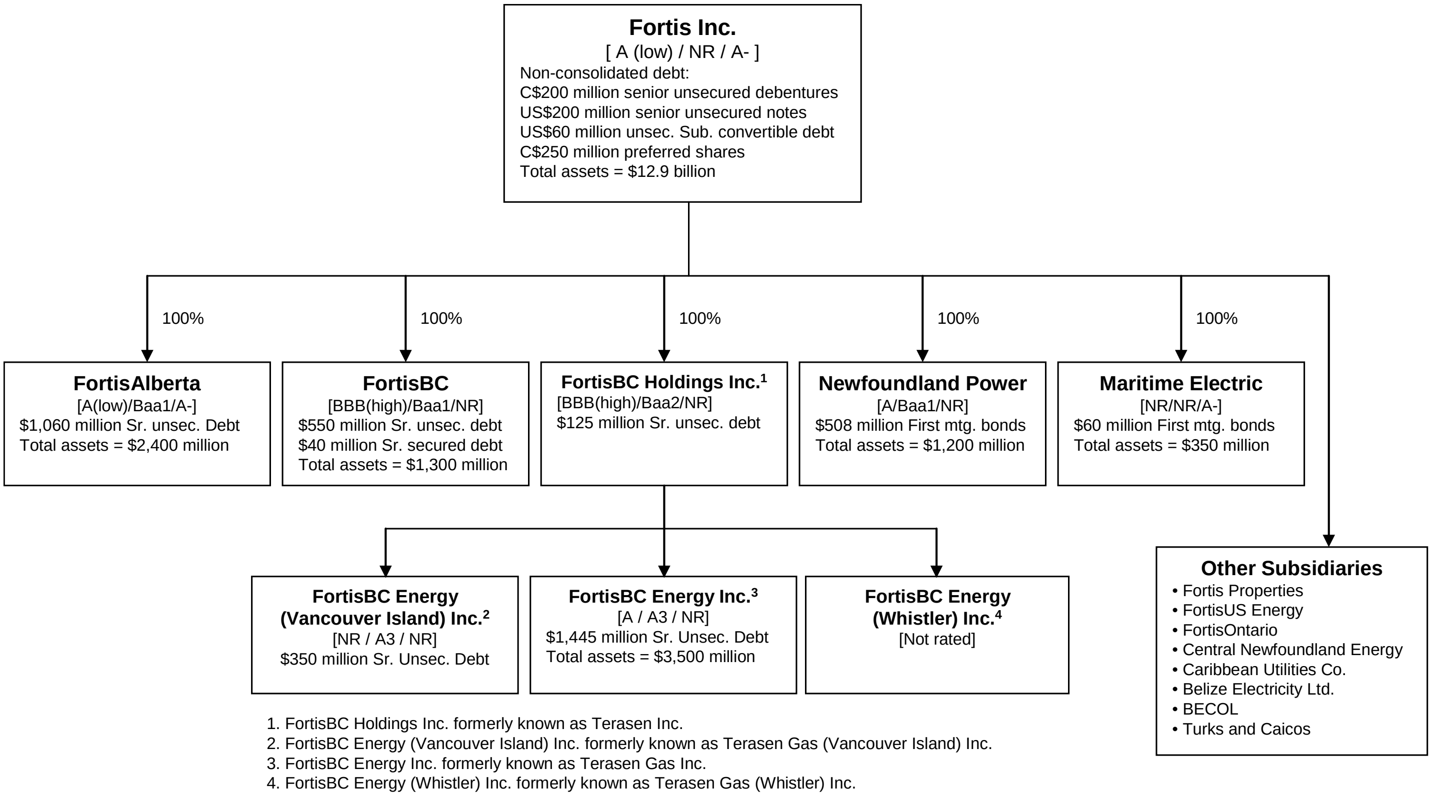
### Exhibit 5: Fortis Inc and Subsidiary Bonds Outstanding

| Issuer Name | Amount ($ million) | Currency | Coupon | Maturity | Issue Date | Refund Type | Security |
|---|---|---|---|---|---|---|---|
| Fortis Inc.[1] | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc.[1] | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **400** | | | | | | |
| | | | | | | | |
| Terasen Inc. | 125 | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| | | | | | | | |
| Terasen Gas Vancouver | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Vancouver | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| **Total Terasen Gas Vancouver** | **350** | | | | | | |
| | | | | | | | |
| **Terasen Gas:** | | | | | | | |
| BC Gas Utility[2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc. | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc. | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc. | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Inc. | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | | |
| | | | | | | | |
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,060** | | | | | | |
| | | | | | | | |
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |
| | | | | | | | |
| Newfoundland Light & Power | 40 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | | |
| | | | | | | | |
| **Maritime Electric** | **60** | CAD | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| | | | | | | | |
| **Total Bonds Outstanding** | **4,538** | | | | | | |

(1) USD Private placements. (2) Terasen Gas was formerly called BC Gas Utility.

Source: Company reports, RBC Capital Markets Research

**Exhibit 6: Fortis Inc Organizational Structure**




Source: Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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**Distribution of Ratings**
**RBC Capital Markets, Credit Research**

| | | | Investment Banking Serv./Past 12 Mos. | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| BUY[TP/O] | 107 | 33.65 | 63 | 58.88 |
| HOLD[SP] | 147 | 46.23 | 98 | 66.67 |
| SELL[U] | 64 | 20.13 | 30 | 46.88 |

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RATINGS REVISION | **CANADIAN CREDIT COMMENT**

**AUGUST 4, 2011**

# Fortis Inc.

## Q2/11: Common Offering Gives Balance Sheet a Boost

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta Inc.** | **Sector Perform** |
| **FortisBC Inc.** | **Sector Perform from Outperform** |
| **FortisBC Energy Inc.** | **Sector Perform** |
| **FortisBC Energy (Van. Island) Inc.** | **Outperform** |
| **Newfoundland Power Inc.** | **Sector Perform** |

**Fortis reports Q2/11 (credit positive):** Fortis reported Q2/11 EPS of $0.33 versus RBC and consensus estimates of $0.36 and $0.35. FFO increased to $180MM, compared to $160MM a year ago (Exhibit 1), mainly due to rate base growth at the western Canadian utilities. Net adjusted debt-to-capital improved to 57.9%, from 60.9% in Q1/11 following the company's $300MM common equity offering in June ($341MM with over-allotment in July). Interest coverage ratios were largely unchanged sequentially. The company's $1.2B capex program for 2011 remains on track, with $519MM spent year-to-date. Also, in July, Fortis terminated its agreement to acquire Central Vermont Public Service Corp. (CVPS) after being out-bid by Gaz Metro, and Fortis received US$19.5MM in termination fees and expenses.

**Gross FCF shortfall funded with common equity:** Fortis generated a Gross FCF shortfall of $152MM after capex of $286MM and dividends of $46MM. This compares to a gross FCF shortfall of $143MM in Q2/10. The shortfall in Q2/11 was funded with proceeds from the company's common equity offering. The company's cash position increased by $212MM, to $298MM, at the end of Q2/11.

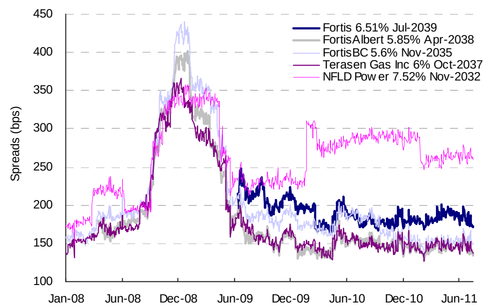
**Less capital markets activity expected this year than last:** Our forecasts indicate FortisAlberta and FortisBC Energy ("FBCE") could tap the debt markets later this year for $200MM and $100MM, respectively. We do not expect to see Fortis Inc. access the capital markets again this year, following its equity offering. This compares to last year when Fortis and its subsidiaries issued $525MM in debt in five tranches, and Fortis Inc. issued of $250MM in preferred shares.

**FortisBC rating lowered to Sector Perform:** FortisBC bonds outperformed the regulated utility peer group over the past few years, mainly in reaction to an improved regulatory framework and credit ratings upgrades. FortisBC bonds now trade 3 or 4 bps back of sister companies FortisAlberta and FortisBC Energy ("FBCE"), which we think is fair given FortisBC's smaller size. We think there is little upside potential left for FortisBC bonds, on a relative value basis, which has prompted us to lower our rating to Sector Perform from Outperform.

**Merging the BC gas utilities:** Fortis intends to file an application with the BCUC in Q3/11 to amalgamate its three B.C.-based gas utilities. If approved, the three utilities would form one legal entity and bonds issued by FBCE and FortisBC Energy (Vancouver Island) Inc. ("FBCV") would rank parri passu. Our Outperform rating on FBCV is based on the view that FBCV spreads would tighten to trade in line with FBCE bonds after the amalgamation.

**Holdco bonds offer favourable pick-up:** We think the discount that Fortis Inc. "holdco" bonds trade at, relative to its regulated utility opco's, provides a favourable spread pick-up (30 to 35 bps) to compensate for the structural subordination, especially when considering the diversified and stable source of cash flow generated by its utility subsidiaries. Furthermore, we think management will remain disciplined with respect to seeking out utility acquisition opportunities in the US, as demonstrated by its willingness to avoid a bidding war on CVPS.

**Fortis Inc Historical Spreads**




Source: ADI, RBC Capital Markets Research

**Fortis Inc. Credit Summary** ($million)

| **Cash Flow Summary ($MM)** | **2009** | **2010** | *2011E* | *2012E* |
|---|---|---|---|---|
| EBITDA | 1,065 | 1,150 | *1,211* | *1,325* |
| **FFO** | **690** | **734** | *710* | *790* |
| Capital expenditures | (1,024) | (1,073) | *(1,212)* | *(1,122)* |
| Dividends | (161) | (281) | *(227)* | *(235)* |
| **Gross FCF** | **(495)** | **(620)** | *(729)* | *(567)* |
| Changes in w/c | (41) | 49 | - | - |
| FCF after w/c | (536) | (571) | *(729)* | *(567)* |
| Acquisitions | - | - | - | - |
| Other investing | (21) | 82 | - | - |
| **FCF before financing** | **(557)** | **(489)** | *(729)* | *(567)* |
| Debt issuance/(repay.) | 551 | 146 | *227* | *467* |
| Common issuance | 46 | 80 | *393* | *100* |
| Preferred issuance | - | 242 | - | - |
| Other financing | (9) | 45 | - | - |
| **Net change in cash** | **31** | **24** | *(109)* | - |
| **Capital Structure** | | | | |
| Total debt | 5,915 | 6,023 | *6,250* | *6,717* |
| Non-controlling int. | 123 | 162 | *162* | *162* |
| Preference Shares | 667 | 912 | *912* | *912* |
| Shareholders' equity | 3,193 | 3,305 | *3,849* | *4,139* |
| **Total capital** | **9,898** | **10,402** | *11,173* | *11,930* |
| Cash and equivalents | 85 | 109 | - | - |
| **Credit Ratios** | | | | |
| Adjusted Debt / Capital[1] | 63% | 62% | *60%* | *60%* |
| Net Adj. Debt / Capital[1] | 63% | 62% | *60%* | *60%* |
| EBITDA / interest | 2.9x | 3.2x | *3.4x* | *3.5x* |
| EBIT / interest | 1.9x | 2.0x | *2.4x* | *2.5x* |
| Total Debt / EBITDA | 5.6x | 5.2x | *5.2x* | *5.1x* |
| FFO / Total Debt | 11.7% | 12.2% | *11.4%* | *11.8%* |

| **Credit Ratios** | **DBRS** | **S&P** | ***Moody's*** |
|---|---|---|---|
| Rating | A(L) | A- | NR |
| Outlook | Stable | Stable | - |

1. 50% equity and 50% debt treatment to pref. shares

Source: RBC Capital Markets estimates, Company reports, Rating agencies

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All values in Canadian dollar unless otherwise noted.

**Priced as of prior trading day's market close, ET (unless otherwise noted).**

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## Highlights (continued)

**Shoring up the balance sheet:** Fortis recently issued $341MM (including over-allotment) of common equity, which is more favourable for credit than what we had expected. In our previous forecasts, we had assumed $200MM in preferred shares (generally 50% equity treatment from the rating agencies) would be issued in 2011 to help fund growth and maintain balance sheet leverage. Proceeds from the equity offering will be used to reduce outstanding credit facilities, inject equity into its utility subsidiaries to fund growth and maintain regulated capital structures, and to fund corporate level projects such as the Waneta Expansion Project.

**Fortis collects termination fee and recoups expenses on termination of CVPS acquisition:** Following the termination of the merger agreement with CVPS in July, Fortis received a US$17.5MM termination fee and US$2MM for associated expenses. While the loss of the acquisition is disappointing from the perspective of improving diversification with another relatively stable regulated utility, we think fixed income investors should take comfort in management's disciplined approach by not entering into a bidding war. We continue to believe management will remain patient until the right opportunity comes along.

**Belize expropriation a minor impact:** Belize Electricity Limited (book value of $112MM at the end of Q2/11) was expropriated by the Government of Belize effective June 20, 2011. Fortis has initiated proceedings for compensation from the Government. We believe this event to be immaterial for fixed income investors as Belize Electricity has contributed minimal earnings since 2008 (less than 1% of total earnings in 2010). As for the non-regulated hydroelectric generation assets in Belize, the Government of Belize has indicated publicly that it does not plan to expropriate these assets.

**Adequate liquidity:** At the end of Q2/11, Fortis Inc. and its subsidiaries had $1.5B available under its $2.1B credit facilities. The company also had $298MM in cash and equivalents. We believe this is adequate to meet the company's near-term requirements.

## Outlook and Funding Expectations

**Modest uplift to five-year capital program to $5.7B:** With $519MM spent at the mid-year mark, Fortis remains on track to achieve its $1.2B capital program for 2011. The company's five-year plan (out to 2015) has been increased to $5.7B from $5.5B (provided at the beginning of the year) to reflect higher capital investments expected at the FortisBC Energy companies, partly offset by lower spending at Belize Electricity. Over the next five years, regulated electric utilities, including FortisAlberta and FortisBC Electric, will receive the bulk of the investment with 61%, followed by regulated gas utilities (23%) and non-regulated operations (16%).

**Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity, and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. Fortis and its subsidiaries do not have any bond maturities in 2011 (Exhibit 5), so any new issuance this year will be to fund capex. For a detailed look at each of the issuing entities, please refer to our report published on April 7, 2011: "Utilities in Canada: Credit Outlook 2011."

- **Fortis Inc.:** After issuing $341MM in common equity, we do not expect to see Fortis Inc. access the capital markets again this year. This compares to 2010, during which Fortis Inc. accessed the capital markets twice: (i) $250MM in cumulative redeemable preference shares (January); and (ii) a US$200MM debt private placement.
- **FortisBC Energy:** For 2011, we are forecasting a modest gross FCF shortfall of about $65MM, which is in line with 2010. We think this shortfall will likely be funded with FBCE's credit facilities but could be termed out with a public debt issuance of $100MM later this year. In 2010, FBCE received a $125MM equity injection from Fortis Inc. to boost its deemed equity base to 40% (from 35%) in response to a recent regulatory decision, and FBCV issued $100MM in debt.
- **FortisAlberta:** We are forecasting that FortisAlberta will need $150MM to $200MM in debt, plus a $60MM equity injection from Fortis, to fund its $420MM capital program in 2011. This compares to 2010, where FortisAlberta issued $125MM in debt and had received $55MM in equity contributions from Fortis Inc.
- **FortisBC:** We are forecasting FortisBC to draw approximately $30MM on its short-term credit facilities, and will not require an equity injection from Fortis, to fund its $99M capital program in 2011. In 2010, FortisBC issued $100MM in debt and received a $10MM equity contribution from Fortis Inc.
- **Newfoundland Power:** We expect Newfoundland Power to fund the majority of its 2011 capital program with cash flow and a minimal amount of borrowing. On July 22, 2011, the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB) denied the application for the $46MM sale of Newfoundland Power's joint-use poles to Bell Aliant. Newfoundland Power is currently reviewing its options, including appealing the decision and providing further evidence to PUB.

## Exhibit 1: Fortis Inc. Historical Consolidated Financials and Forecasts

| Fortis Inc. | Annual | | | | Quarterly | | | | | Forecasts | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Consolidated ($ millions)** | **2009** | **2010** | **Q2/10** | **Q3/10** | **Q4/10** | **Q1/11** | **Q2/11** | **LTM** | **YTD** | *2011E* | *2012E* |
| **Earnings Summary** | | | | | | | | | | | |
| EBITDA | 1,065 | 1,150 | 267 | 265 | 301 | 348 | 279 | 1,193 | 627.0 | *1,211* | *1,325* |
| EBIT | 701 | 740 | 169 | 148 | 198 | 245 | 176 | 767 | 421.0 | *861* | *940* |
| Gross interest | 362 | 361 | 89 | 92 | 90 | 94 | 93 | 369 | 187.0 | *360* | *374* |
| Net income (as reported) | 292 | 323 | 66 | 55 | 94 | 125 | 69 | 343 | 194.0 | *350* | *396* |
| **Cash Flow Summary** | | | | | | | | | | | |
| **FFO** | 690 | 734 | 160 | 165 | 209 | 242 | 180 | 796 | 422 | *710* | *790* |
| Capital Expenditures | (1,024) | (1,073) | (244) | (268) | (370) | (233) | (286) | (1,157) | (519) | *(1,212)* | *(1,122)* |
| Preferred dividends | (18) | (28) | (8) | (7) | (7) | (7) | (8) | (29) | (15) | *(28)* | *(28)* |
| Dividends (common & non-cont.) | (143) | (253) | (51) | (50) | (54) | (53) | (38) | (195) | (91) | *(199)* | *(207)* |
| **Gross free cash flow (FCF)** | **(495)** | **(620)** | **(143)** | **(160)** | **(222)** | **(51)** | **(152)** | **(585)** | **(203)** | *(729)* | *(567)* |
| Changes in working capital | (41) | 49 | 44 | (36) | (8) | 57 | 48 | 61 | 105 | - | - |
| Gross FCF after working capital | (536) | (571) | (99) | (196) | (230) | 6 | (104) | (524) | (98) | *(729)* | *(567)* |
| Divestitures / Acquisitions | | | | | | | | | | - | - |
| Other investing activities | (21) | 82 | 15 | 15 | 37 | 14 | 18 | 84 | 32 | - | - |
| **Free cash flow before financing** | **(557)** | **(489)** | **(84)** | **(181)** | **(193)** | **20** | **(86)** | **(440)** | **(66)** | *(729)* | *(567)* |
| Debt drawn/(repaid) | 551 | 146 | 45 | 155 | 172 | (87) | (32) | 208 | (119) | *227* | *467* |
| Issue of common shares[1] | 46 | 80 | 16 | 19 | 22 | 27 | 290 | 358 | 317 | *393* | *100* |
| Issue of preference shares | - | 242 | - | - | - | - | - | - | - | - | - |
| Other financing activities | (5) | 45 | 1 | - | 44 | 17 | 40 | 101 | 57 | - | - |
| F/X gain/(loss) | (4) | - | 1 | - | - | - | - | - | - | - | - |
| **Net increase (decrease) in cash** | **31** | **24** | **(21)** | **(7)** | **45** | **(23)** | **212** | **227** | **189** | *(109)* | - |
| **Capital Structure** | | | | | | | | | | | |
| Total debt | 5,915 | 6,023 | 5,742 | 5,875 | 6,023 | 5,915 | 5,857 | 5,857 | | *6,250* | *6,717* |
| Non-controlling interest | 123 | 162 | 125 | 122 | 162 | 175 | 178 | 178 | | *162* | *162* |
| Preference Shares | 667 | 912 | 912 | 912 | 912 | 912 | 912 | 912 | | *912* | *912* |
| Shareholders' equity | 3,193 | 3,305 | 3,248 | 3,255 | 3,305 | 3,397 | 3,738 | 3,738 | | *3,849* | *4,139* |
| **Total capital** | **9,898** | **10,402** | **10,027** | **10,164** | **10,402** | **10,399** | **10,685** | **10,685** | | **11,173** | **11,930** |
| Cash and equivalents | 85 | 109 | 71 | 64 | 109 | 86 | 298 | 298 | | - | - |
| **Credit Ratios[2]** | | | | | | | | | | | |
| Total Debt / Capital | 59.8% | 57.9% | 57.3% | 57.8% | 57.9% | 56.9% | 54.8% | 54.8% | | *55.9%* | *56.3%* |
| Adjusted Debt / Capital[2] | 63.1% | 62.3% | 61.8% | 62.3% | 62.3% | 61.3% | 59.1% | 59.1% | | *60.0%* | *60.1%* |
| Net Debt / Capital | 59.4% | 57.5% | 57.0% | 57.5% | 57.5% | 56.5% | 53.5% | 53.5% | | *55.9%* | *56.3%* |
| Net Adjusted Debt / Capital[2] | 62.8% | 61.9% | 61.5% | 62.0% | 61.9% | 60.9% | 57.9% | 57.9% | | *60.0%* | *60.1%* |
| (FFO + interest) / interest | 2.9x | 3.0x | 2.9x | 2.9x | 3.0x | 3.1x | 3.2x | 3.2x | | *3.0x* | *3.1x* |
| EBITDA / interest | 2.9x | 3.2x | 3.0x | 3.1x | 3.2x | 3.2x | 3.2x | 3.2x | | *3.4x* | *3.5x* |
| EBIT / interest | 1.9x | 2.0x | 2.0x | 2.0x | 2.0x | 2.1x | 2.1x | 2.1x | | *2.4x* | *2.5x* |
| Total Debt / EBITDA | 5.6x | 5.2x | 5.2x | 5.2x | 5.2x | 5.0x | 4.9x | 4.9 | | *5.2* | *5.1* |
| FFO / Total Debt | 11.7% | 12.2% | 11.9% | 11.9% | 12.3% | 13.1% | 13.6% | 13.6% | | *11.4%* | *11.8%* |

1. Issue of common shares includes the company's DRIP, which we have assumed to be $100MM in 2011 and 2012.
2. Adjusted leverage ratios incorporate a 50%/50% debt/equity treatment for preferred equity.

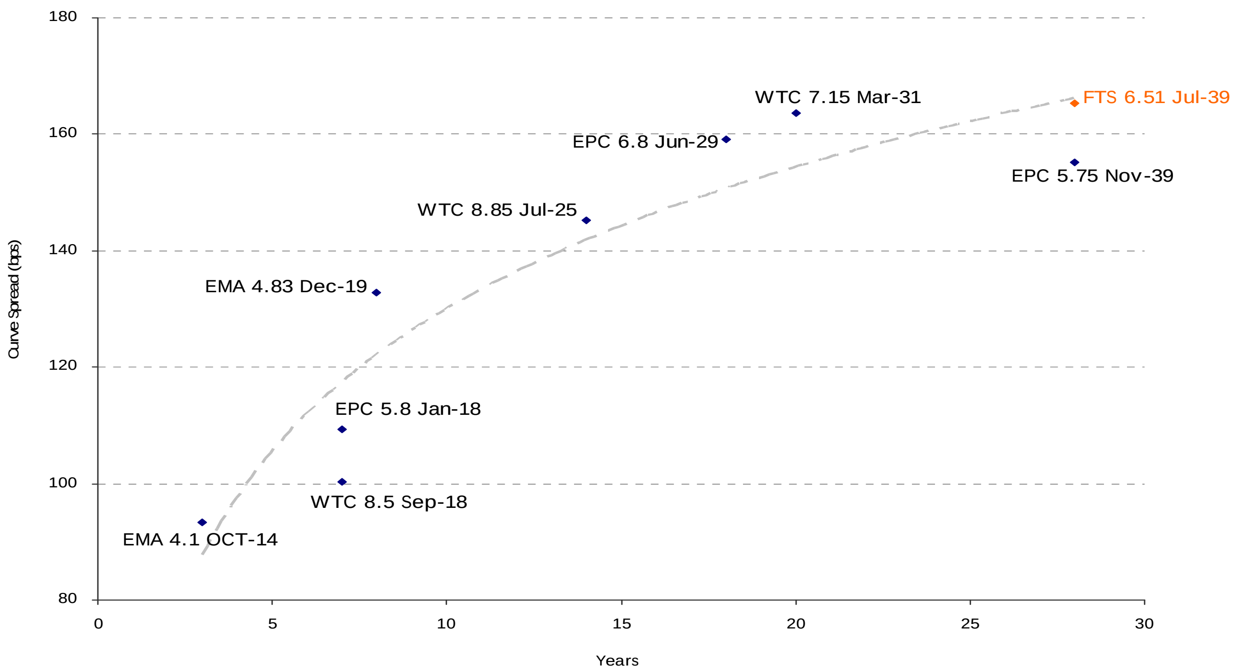
Source: Company reports, RBC Capital Markets estimates

## Exhibit 2: Capital Spending by Subsidiary ($ millions)

| | FortisBC Energy Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| 2011F | 271 | 420 | 99 | 73 | 46 | **909** | 83 | 183 | 27 | **1,202** |
| 2010A | 253 | 379 | 139 | 78 | 48 | **897** | 72 | 85 | 19 | **1,073** |

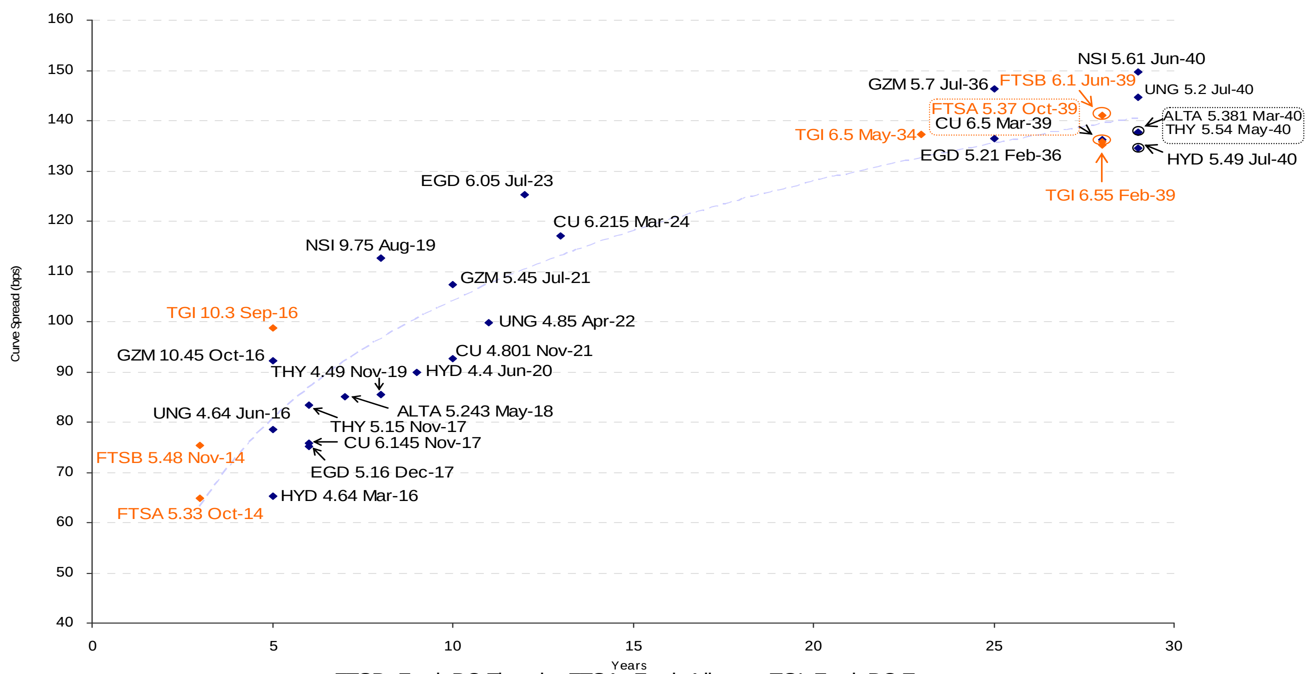
Source: Company reports

**Exhibit 3: Relative Value Chart - Canadian Utility Holding Companies**




Source: RBC Capital Markets Research

**Exhibit 4: Relative Value Chart - Canadian Regulated Utilities**




FTSB: FortisBC Electric, FTSA: FortisAlberta, TGI: FortisBC Energy

Source: RBC Capital Markets Research

## Exhibit 5: Fortis Inc and Subsidiary Bonds Outstanding

| Issuer Name | Amount ($MM) | Currency | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Fortis Inc. | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc. | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **400** | | | | | | |
| | | | | | | | |
| **Terasen Inc.** | **125** | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| **Terasen Gas:** | | | | | | | |
| BC Gas Utility[1,2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[1,2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[1,2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | | |
| **Total TGV** | **350** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,060** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Newfoundland Light & Power | 40 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | | |
| | | | | | | | |
| **Maritime Electric** | **60** | CAD | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| | | | | | | | |
| **Total Bonds Outstanding** | **4,538** | | | | | | |

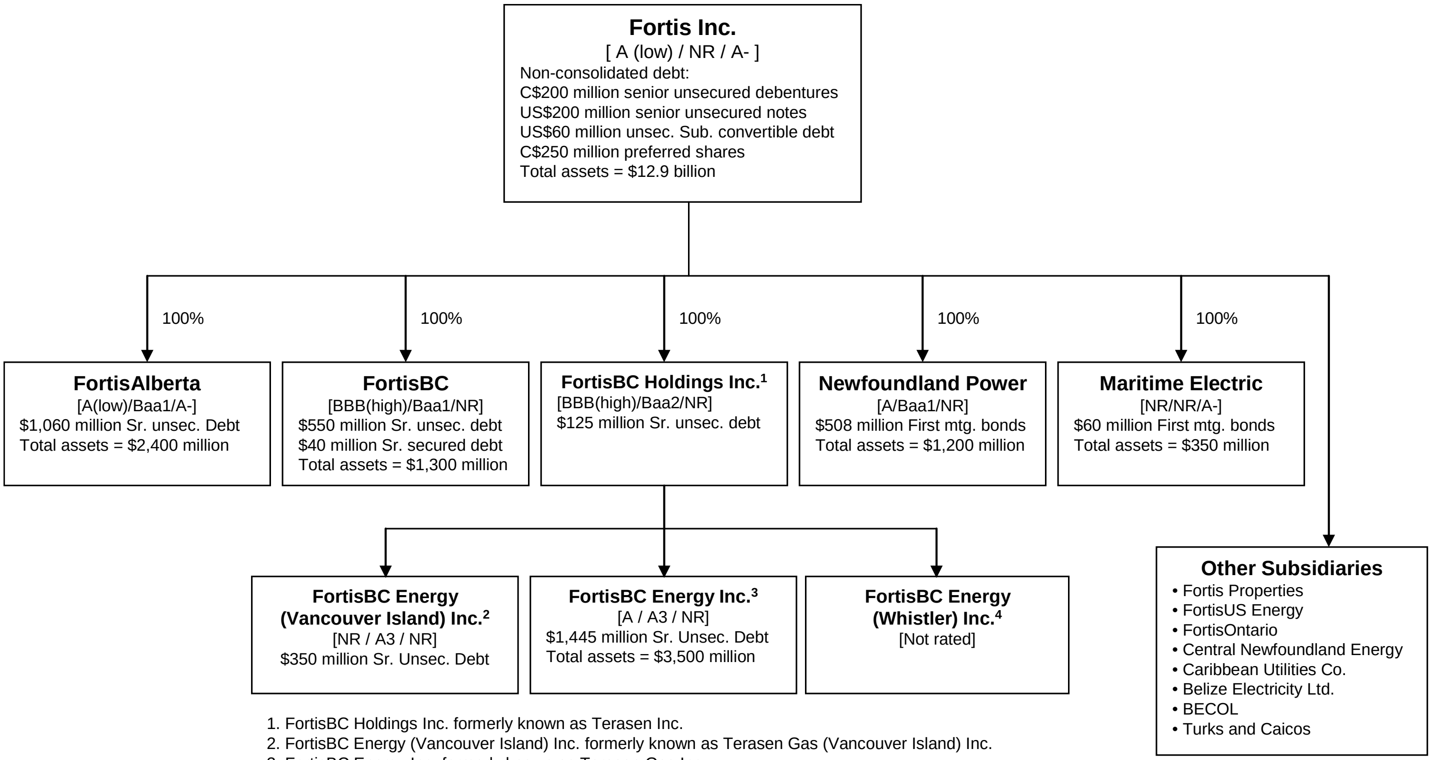
(1) Terasen Gas Inc. was formerly called BC Gas Utility.

(2) Terasen Gas Inc. has been renamed as FortisBC Energy Inc.

(3) Terasen Gas (Vancouver Island) Inc. has been renamed as FortisBC Energy (Vancouver Island) Inc.

Source: Company reports, RBC Capital Markets Research

**Exhibit 6: Fortis Inc Organizational Structure**




1. FortisBC Holdings Inc. formerly known as Terasen Inc.
2. FortisBC Energy (Vancouver Island) Inc. formerly known as Terasen Gas (Vancouver Island) Inc.
3. FortisBC Energy Inc. formerly known as Terasen Gas Inc.
4. FortisBC Energy (Whistler) Inc. formerly known as Terasen Gas (Whistler) Inc.

Source: Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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| HOLD[SP] | 166 | 46.76 | 106 | 63.86 |
| SELL[U] | 67 | 18.87 | 29 | 43.28 |

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COMPANY UPDATE | **CANADIAN CREDIT COMMENT**

**NOVEMBER 4, 2011**

# Fortis Inc.

## Q3/11: Another Stable Quarter

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta Inc.** | **Sector Perform** |
| **FortisBC Inc.** | **Sector Perform** |
| **FortisBC Energy Inc.** | **Sector Perform** |
| **FortisBC Energy (Van. Island) Inc.** | **Outperform** |
| **Newfoundland Power Inc.** | **Sector Perform** |

**Fortis reports Q3/11 (credit neutral):** Fortis reported Q3/11 normalized EPS of $0.25 compared to RBC and consensus estimates of $0.24. Overall, Canadian regulated utilities posted a good quarter with $40MM of earnings which was in-line with RBC estimate of $38MM, and all the other segments were within +/- $1MM. Following the in-line quarter, key credit metrics remained largely unchanged sequentially, with net adjusted debt-to-capital and EBITDA-to-interest ending the quarter at 58% and 3.3x, respectively (Exhibit 1).

**Gross FCF shortfall funded with cash:** Fortis generated a gross FCF shortfall of $180MM, after capex of $287MM and dividends of $47MM compared to a shortfall of $160MM a year ago. The gap was essentially funded with cash proceeds from the common equity offering in the previous quarter.

**Capital investment plan remains on track:** Having spent $806MM through the first nine months of this year, Fortis remains on track to reach its $1.2B capital program for 2011. Management expects a comparable capex figure next year, and maintained its five-year capital program guidance of $5.7B through to 2015.

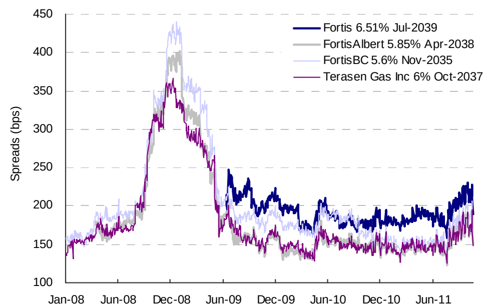
**Newfoundland Power sells joint-use poles:** At the end of the quarter, Newfoundland Power received regulatory approval to sell 40% of its joint-use poles to Bell Aliant. The sale brought in $46MM to the company in October.

**Application filed to amalgamate BC gas utilities:** Fortis filed an application in November to the BCUC to amalgamate its three BC-based gas utilities. Pending approval from the BCUC and consent from the BC government, the amalgamation will become effective January 1, 2013. If approved, the three utilities would form one legal entity and bonds issued by FortisBC Energy (FBCE) and FortisBC Energy (Vancouver Island) (FBCV) Inc would rank parri-passu. Our Outperform rating on FBCV is based on the view that the spreads would tighten to trade in-line with FBCE bonds following the amalgamation.

**Approximately $500MM in external funding expected over next 12 months:** We think FortisAlberta and FortisBC Energy Inc. could each potentially issue debt in the order of $100MM over the next 12 months, with FortisAlberta likely not until Q4/12. At the holding company level, Fortis Inc. may need to raise external capital in the order of $250MM-$350MM next year to fund projects such as the Waneta hydroelectric plant and equity injections down to its utility opcos.

**HoldCo bonds offer good value:** We continue to think the discount that Fortis Inc. "holdco" bonds trade at, relative to its regulated utility opco's, provides a favourable spread pick-up (45 to 60 bps) to compensate for the structural subordination, especially when considering the diversified and stable source of cash flow generated by its utility subsidiaries. Furthermore, we think management will remain disciplined with respect to seeking out utility acquisition opportunities in the US, as demonstrated by its willingness to avoid getting into a bidding war over Central Vermont Power Public Service (CVPS) earlier this year.

**Historical Spreads**




Source: ADI, RBC Capital Markets Research

**Fortis Inc. Credit Summary**

| Cash Flow Summary ($MM) | 2010 | 2011E | 2012E | 2012E |
|---|---|---|---|---|
| **FFO** | **734** | *710* | *790* | *830* |
| Capital expenditures | (1,073) | *(1,212)* | *(1,122)* | *(1,020)* |
| Dividends | (281) | *(227)* | *(235)* | *(243)* |
| **Gross FCF** | **(620)** | *(729)* | *(567)* | *(433)* |
| Changes in w/c | 49 | *25* | - | - |
| FCF after w/c | (571) | *(704)* | *(567)* | *(433)* |
| Acquisitions | - | - | - | - |
| Other investing | 82 | - | - | - |
| **FCF before financing** | **(489)** | *(704)* | *(567)* | *(433)* |
| Debt issuance/(repay.) | 146 | *202* | *503* | *333* |
| Common issuance | 80 | *393* | *64* | *100* |
| Preferred issuance | 242 | - | - | - |
| Other financing | 45 | - | - | - |
| **Net change in cash** | **24** | *(109)* | - | - |
| **Capital Structure ($MM)** | | | | |
| Total debt | 6,023 | *6,225* | *6,728* | *7,062* |
| Non-controlling int. | 162 | *162* | *162* | *162* |
| Preference Shares | 912 | *912* | *912* | *912* |
| Shareholders' equity | 3,305 | *3,849* | *4,104* | *4,400* |
| **Total capital** | **10,402** | *11,148* | *11,906* | *12,535* |
| Cash and equivalents | 109 | - | - | - |
| **Credit Ratios** | | | | |
| Adjusted Debt / Capital[1] | 62% | *60%* | *60%* | *60%* |
| Net Adj. Debt / Capital[1] | 62% | *60%* | *60%* | *60%* |
| EBITDA / interest | 3.2x | *3.4x* | *3.6x* | *3.5x* |
| EBIT / interest | 2.0x | *2.4x* | *2.5x* | *2.5x* |
| Total Debt / EBITDA | 5.2x | *5.1x* | *5.1x* | *5.0x* |
| FFO / Total Debt | 12.2% | *11.4%* | *11.7%* | *11.8%* |
| **Credit Ratios** | | **DBRS** | **S&P** | ***Moody's*** |
| Rating | | A(L) | A- | NR |
| Outlook | | Stable | Stable | - |

1. 50% equity and 50% debt treatment to pref. shares

Source: RBC Capital Markets estimates, Company reports, Rating agencies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All values in Canadian dollar unless otherwise noted.

**Priced as of prior trading day's market close, ET (unless otherwise noted).**

**For Required Conflicts Disclosures, please see Page 9.**

## Highlights

**Belize Update:** Following the expropriation of Belize Electricity Limited (book value of $112MM at the end of Q2/11) in June, Fortis has commissioned an independent valuation of its previous investment in the asset and expects to submit a claim to the Government of Belize in Q4/11. For fixed income investors, we believe the outcome of the claim to be immaterial as the asset has contributed minimal earnings since 2008 (less than 1% of total earnings in 2010). With respect to the non-regulated hydroelectric generation assets in Belize, the Government of Belize has indicated that it does not plan to expropriate these assets.

**Newfoundland Power sells joint-use poles:** At the end of the quarter, Newfoundland Power received regulatory approval to sell 40% of its joint-use poles to Bell Aliant. The sale brought in $46MM to the company in October.

**Fortis Properties acquires a hotel in Winnipeg:** Shortly after the quarter, Fortis Properties acquired the 160-room, Hilton Suites Winnipeg Airport hotel for $25MM in October.

**Termination fee collected and expenses recouped from CVPS:** Following the termination of the merger agreement with CVPS, Fortis received $11MM (after-tax) in July. More importantly, the discipline and patience management has shown by not entering into a bidding war should give additional comfort to fixed income investors as the company continues its search for a major utility acquisition in the U.S.

**Work continues on Waneta Expansion:** The 335MW, hydro project in BC is currently running on schedule and is projected to be in service in the spring of 2015, at an estimated cost of $900MM. This is a non-regulated asset that will sell energy and capacity to BC Hydro and FortisBC Electric under 40-year power sales contracts.

**Adequate liquidity:** At the end of Q3/11, Fortis Inc. and its subsidiaries had $108MM of cash on hand and $1.9B available under its $2.3B credit facilities. Fortis improved its liquidity by increasing the corporate credit facility to $800MM (from $600) and extending the maturity to 2015 (from 2012). Also during the quarter, FortisAlberta raised its committed facility to $250MM (from $200MM) with the same maturity of 2015. We believe this is more than adequate to meet near-term funding needs.

## Outlook and Funding Expectations

**Five-year capital program of $5.7B:** Having spent $806MM through the first nine months of this year, Fortis remains on track to reach its $1.2B capital program for 2011. The company maintained its five-year (out to 2015) capital plan guidance at $5.7B. Under the plan, regulated electric utilities, including FortisAlberta and FortisBC Electric, will receive the bulk of the investment with 61%, followed by regulated gas utilities (23%) and non-regulated operations (16%).

**Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta and FortisBC) will continue to require equity from Fortis in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity, and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. Fortis and its subsidiaries do not have any remaining bond maturities in 2011 and only has a small $15MM maturity at FortisBC next year (Exhibit 5). New issuance in 2012 will essentially be for the purpose of funding capex.

- **Fortis Inc.:** After issuing $341MM in common equity in June of this year, we do not expect to see Fortis Inc. access the capital markets again this year. Looking out to 2012, Fortis Inc. may need to raise external capital in the order of $250MM-$350MM to fund projects such as the Waneta hydroelectric plant and equity injections down to its utility opcos. We would expect a mix of debt and equity (common and prefs) to maintain its consolidated capital structure near 60%.
- **FortisBC Energy:** We think funding needs at FortisBC Energy will be fairly light through to the end of next year, with FFO expected to fund the majority of capex and dividends (expected to be ~$200MM and ~50MM annually, respectively). At most we could see the utility issue in the order of $100MM over the next year or so.
- **FortisAlberta:** FortisAlberta had $73MM drawn on its credit facilities at the end of Q3/11, which were likely paid down with proceeds from the company's $125MM bond issued on October 14, 2011. Year to date, the utility has received a $30MM equity injection from its parent, and by our estimate could use another $30MM in Q4/11. For 2012, our estimate is that FortisAlberta could issue another $100MM-$150MM in debt in the latter part of the year and receive another $50MM-$60MM equity injection to fund capital spending and maintain its regulated capital structure.
- **FortisBC:** FortisBC last issued debt in 2010 ($100MM), and also received a $10MM equity contribution from Fortis Inc. that year. We could see FortisBC tap the debt markets on a biannual basis for something in the range of $100MM. We think equity contributions over the next couple of years will be minimal.
- **Newfoundland Power:** We expect Newfoundland Power to fund the majority of its 2011 capital program with cash flow and a minimal amount of borrowing.

## Exhibit 1: Fortis Inc. Historical Consolidated Financials and Forecasts

| Fortis Inc. | Annual | | | | Quarterly | | | | | | Forecasts | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Consolidated ($ millions)** | **2009** | **2010** | **Q3/10** | **Q4/10** | **Q1/11** | **Q2/11** | **Q3/11** | **LTM** | **YTD** | *2011E* | *2012E* | *2013E* |
| **Earnings Summary** | | | | | | | | | | | | |
| EBITDA | 1,065 | 1,150 | 265 | 301 | 348 | 279 | 273 | 1,201 | 900 | *1,211* | *1,325* | *1,404* |
| EBIT | 701 | 740 | 148 | 198 | 245 | 176 | 168 | 787 | 589 | *861* | *940* | *990* |
| Gross interest | 362 | 361 | 92 | 90 | 94 | 93 | 92 | 369 | 279 | *360* | *372* | *402* |
| **Cash Flow Summary** | | | | | | | | | | | | |
| **FFO** | 690 | 734 | 165 | 209 | 242 | 180 | 154 | 785 | 576 | *710* | *790* | *830* |
| Capital Expenditures | (1,024) | (1,073) | (268) | (370) | (233) | (286) | (287) | (1,176) | (806) | *(1,212)* | *(1,122)* | *(1,020)* |
| Preferred dividiends | (18) | (28) | (7) | (7) | (7) | (8) | (7) | (29) | (22) | *(28)* | *(28)* | *(28)* |
| Dividends (common & non-cont.) | (143) | (253) | (50) | (54) | (53) | (38) | (40) | (185) | (131) | *(199)* | *(207)* | *(215)* |
| **Gross free cash flow (FCF)** | **(495)** | **(620)** | **(160)** | **(222)** | **(51)** | **(152)** | **(180)** | **(605)** | **(383)** | *(729)* | *(567)* | *(433)* |
| Changes in working capital | (41) | 49 | (36) | (8) | 57 | 48 | (3) | 94 | 102 | *25* | *-* | *-* |
| Gross FCF after working capital | (536) | (571) | (196) | (230) | 6 | (104) | (183) | (511) | (281) | *(704)* | *(567)* | *(433)* |
| Divestitures / Acquisitions | | | | | | | | | | *-* | *-* | *-* |
| Other investing activities | (21) | 82 | 15 | 37 | 14 | 18 | 18 | 87 | 50 | *-* | *-* | *-* |
| **Free cash flow before financing** | **(557)** | **(489)** | **(181)** | **(193)** | **20** | **(86)** | **(165)** | **(424)** | **(231)** | *(704)* | *(567)* | *(433)* |
| Debt drawn/(repaid) | 551 | 146 | 155 | 172 | (87) | (32) | (86) | (33) | (205) | *202* | *503* | *333* |
| Issue of common shares[1] | 46 | 80 | 19 | 22 | 27 | 290 | 40 | 379 | 357 | *393* | *64* | *100* |
| Issue of preference shares | - | 242 | - | - | - | - | - | - | - | *-* | *-* | *-* |
| Other financing activities | (5) | 45 | - | 44 | 17 | 40 | 20 | 121 | 77 | *-* | *-* | *-* |
| F/X gain/(loss) | (4) | - | - | - | - | - | 1 | 1 | 1 | *-* | *-* | *-* |
| **Net increase (decrease) in cash** | **31** | **24** | **(7)** | **45** | **(23)** | **212** | **(190)** | **44** | **(1)** | *(109)* | - | - |
| **Capital Structure** | | | | | | | | | | | | |
| Total debt | 5,915 | 6,023 | 5,875 | 6,023 | 5,915 | 5,857 | 5,837 | 5,837 | | *6,225* | *6,728* | *7,062* |
| Non-controlling interest | 123 | 162 | 122 | 162 | 175 | 178 | 205 | 205 | | *162* | *162* | *162* |
| Preference Shares | 667 | 912 | 912 | 912 | 912 | 912 | 912 | 912 | | *912* | *912* | *912* |
| Shareholders' equity | 3,193 | 3,305 | 3,255 | 3,305 | 3,397 | 3,738 | 3,809 | 3,809 | | *3,849* | *4,104* | *4,400* |
| **Total capital** | **9,898** | **10,402** | **10,164** | **10,402** | **10,399** | **10,685** | **10,763** | **10,763** | | **11,148** | **11,906** | **12,535** |
| Cash and equivalents | 85 | 109 | 64 | 109 | 86 | 298 | 108 | 108 | | - | - | - |
| **Credit Ratios[2]** | | | | | | | | | | | | |
| Total Debt / Capital | 59.8% | 57.9% | 57.8% | 57.9% | 56.9% | 54.8% | 54.2% | 54.2% | | *55.8%* | *56.5%* | *56.3%* |
| Adjusted Debt / Capital[2] | 63.1% | 62.3% | 62.3% | 62.3% | 61.3% | 59.1% | 58.5% | 58.5% | | *59.9%* | *60.3%* | *60.0%* |
| Net Debt / Capital | 59.4% | 57.5% | 57.5% | 57.5% | 56.5% | 53.5% | 53.8% | 53.8% | | *55.8%* | *56.5%* | *56.3%* |
| Net Adjusted Debt / Capital[2] | 62.8% | 61.9% | 62.0% | 61.9% | 60.9% | 57.9% | 58.0% | 58.0% | | *59.9%* | *60.3%* | *60.0%* |
| (FFO + interest) / interest | 2.9x | 3.0x | 2.9x | 3.0x | 3.1x | 3.2x | 3.1x | 3.1x | | *3.0x* | *3.1x* | *3.1x* |
| EBITDA / interest | 2.9x | 3.2x | 3.1x | 3.2x | 3.2x | 3.2x | 3.3x | 3.3x | | *3.4x* | *3.6x* | *3.5x* |
| EBIT / interest | 1.9x | 2.0x | 2.0x | 2.0x | 2.1x | 2.1x | 2.1x | 2.1x | | *2.4x* | *2.5x* | *2.5x* |
| Total Debt / EBITDA | 5.6x | 5.2x | 5.2x | 5.2x | 5.0x | 4.9x | 4.9x | 4.9 | | *5.1* | *5.1* | *5.0* |
| FFO / Total Debt | 11.7% | 12.2% | 11.9% | 12.3% | 13.1% | 13.6% | 13.4% | 13.4% | | *11.4%* | *11.7%* | *11.8%* |

1. Issue of common shares includes the company's DRIP, which we have assumed to be $100MM in 2011 and 2012.
2. Adjusted leverage ratios incorporate a 50%/50% debt/equity treatment for preferred equity.

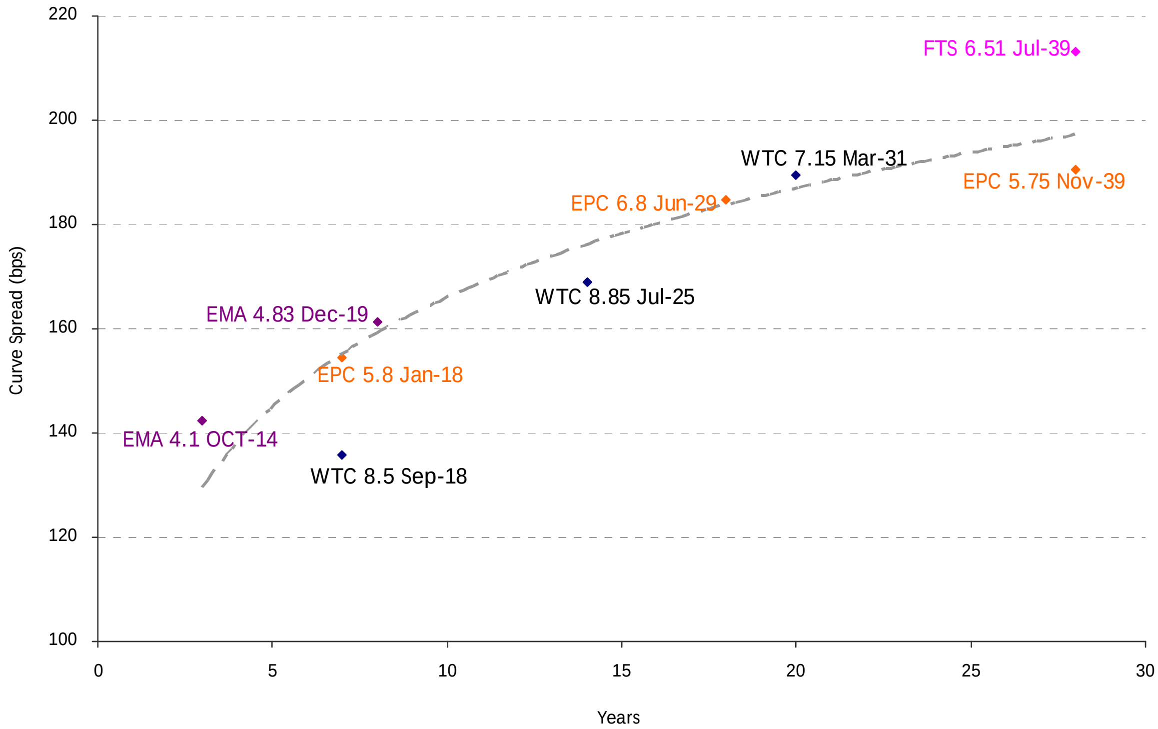
Source: Company reports, RBC Capital Markets estimates

## Exhibit 2: Capital Spending by Subsidiary ($ millions)

| | FortisBC Energy Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| 2011F | 271 | 420 | 99 | 73 | 46 | **909** | 83 | 183 | 27 | **1,202** |
| 2010A | 253 | 379 | 139 | 78 | 48 | **897** | 72 | 85 | 19 | **1,073** |

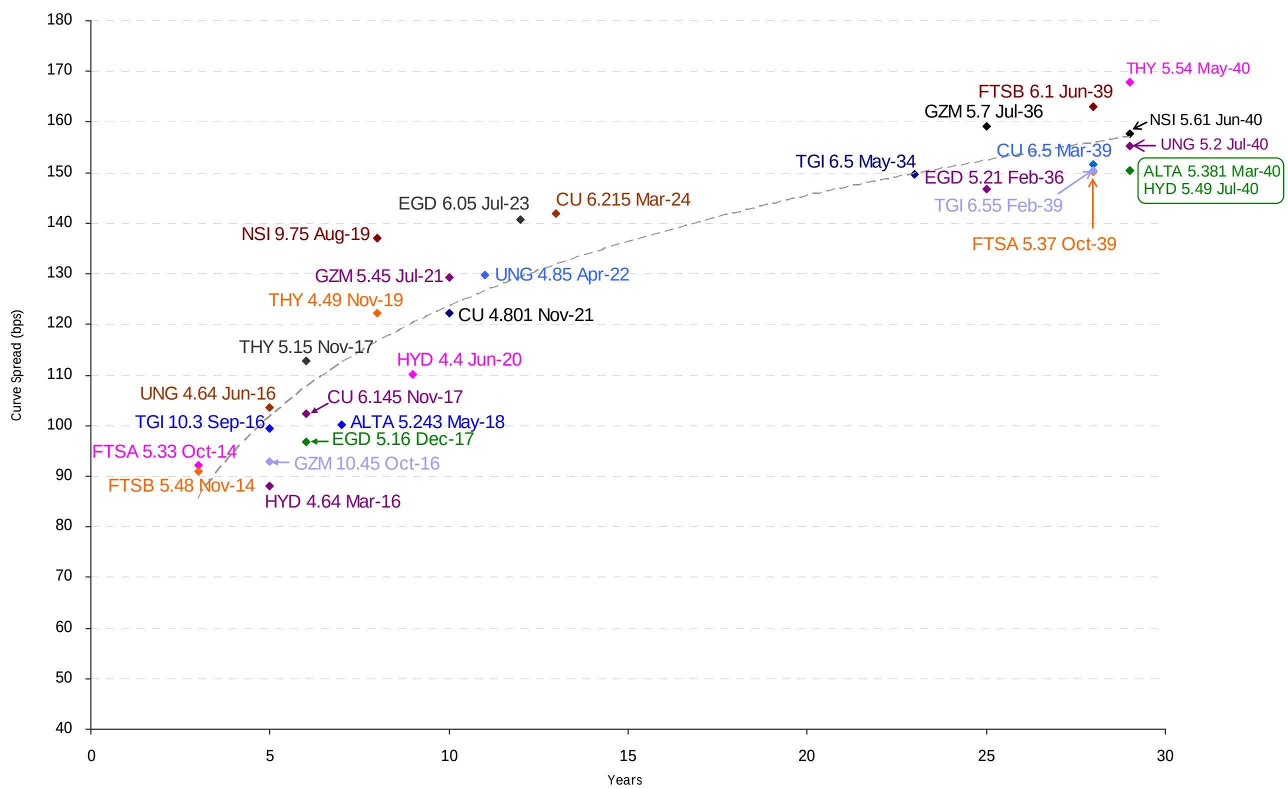
Source: Company reports

**Exhibit 3: Relative Value Chart - Canadian Utility Holding Companies**




Source: RBC Capital Markets Research

**Exhibit 4: Relative Value Chart - Canadian Regulated Utilities**




Source: RBC Capital Markets Research

## Exhibit 5: Fortis Inc and Subsidiary Bonds Outstanding

| Issuer Name | Amount ($MM) | Currency | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Fortis Inc. | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc. | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **400** | | | | | | |
| **Terasen Inc.** | **125** | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| **Terasen Gas:** | | | | | | | |
| BC Gas Utility[1,2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[1,2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[1,2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| **Total Terasen Gas** | **1,445** | | | | | | |
| **Total TGV** | **350** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.54% | 10/18/2041 | 10/14/2011 | Call +39.5 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,185** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |

| Issuer Name | Amount ($MM) | | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Newfoundland Light & Power | 40 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 40 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 50 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 71 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 60 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 70 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 65 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **508** | | | | | | |
| **Maritime Electric** | **60** | CAD | 6.054% | 04/2/2038 | 03/27/2008 | Call +50 bps | First Mortgage |
| **Total Bonds Outstanding** | **4,663** | | | | | | |

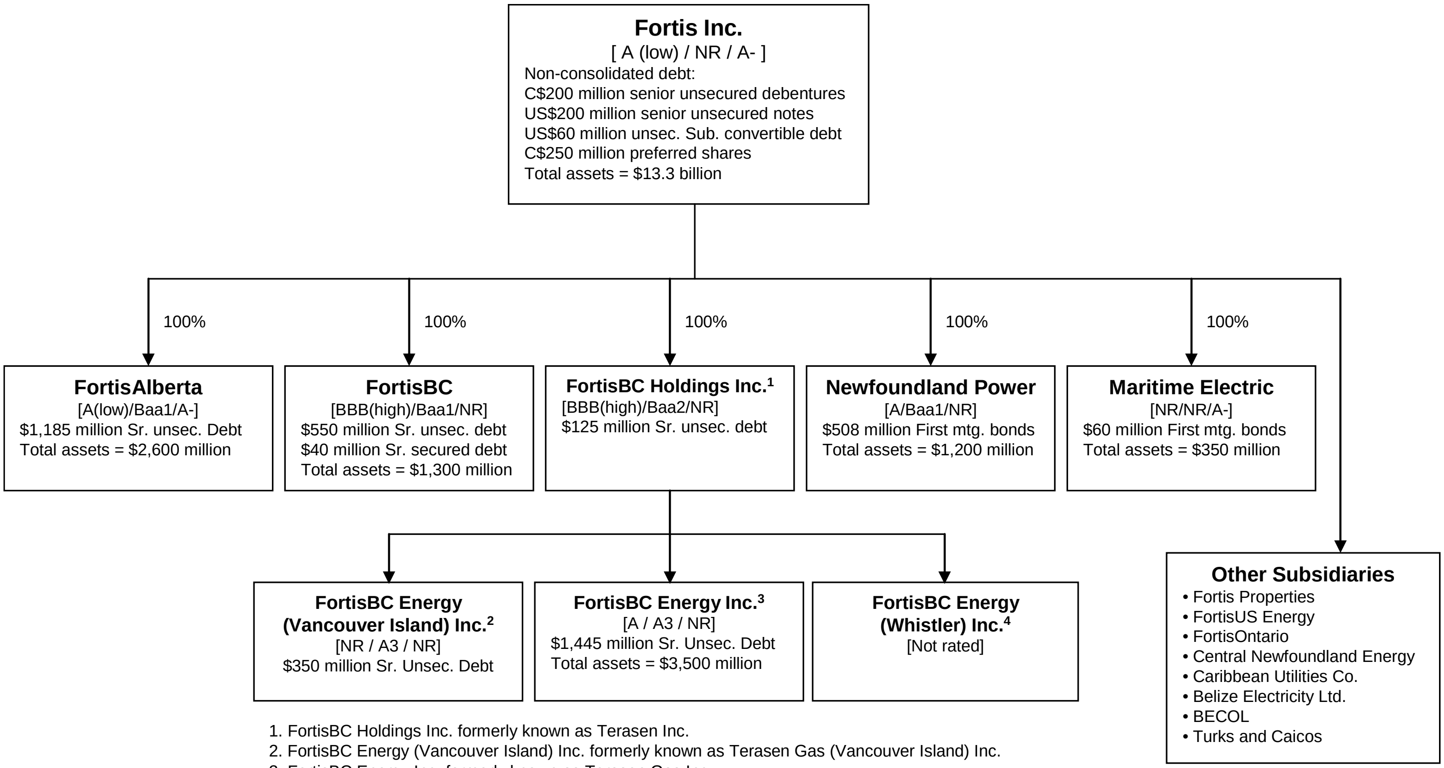
(1) Terasen Gas Inc. was formerly called BC Gas Utility.

(2) Terasen Gas Inc. has been renamed as FortisBC Energy Inc.

(3) Terasen Gas (Vancouver Island) Inc. has been renamed as FortisBC Energy (Vancouver Island) Inc.

Source: Company reports, RBC Capital Markets Research

**Exhibit 6: Fortis Inc Organizational Structure**



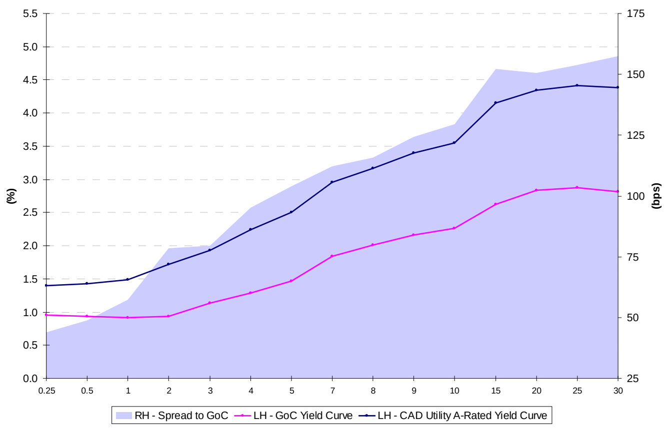

1. FortisBC Holdings Inc. formerly known as Terasen Inc.
2. FortisBC Energy (Vancouver Island) Inc. formerly known as Terasen Gas (Vancouver Island) Inc.
3. FortisBC Energy Inc. formerly known as Terasen Gas Inc.
4. FortisBC Energy (Whistler) Inc. formerly known as Terasen Gas (Whistler) Inc.

Source: Company reports, RBC Capital Markets Research

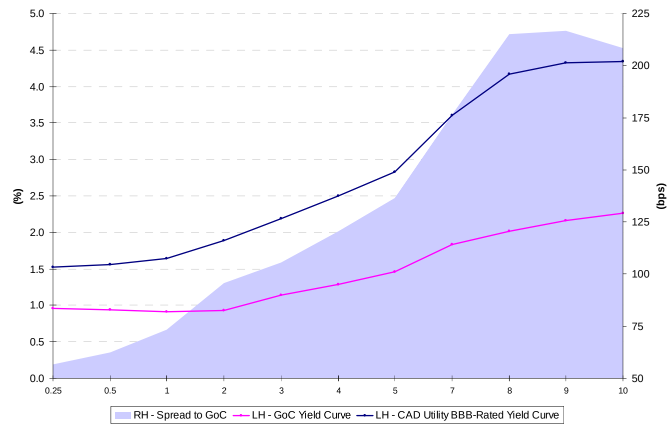
**Diversified group of regulated utility operating companies provide stability:** Fortis' diversified portfolio of low-risk monopoly electricity and gas distribution utilities provides a stable source of cash flow to service holdco debt. Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service holdco debt. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

# Change in Market Yields & Spreads

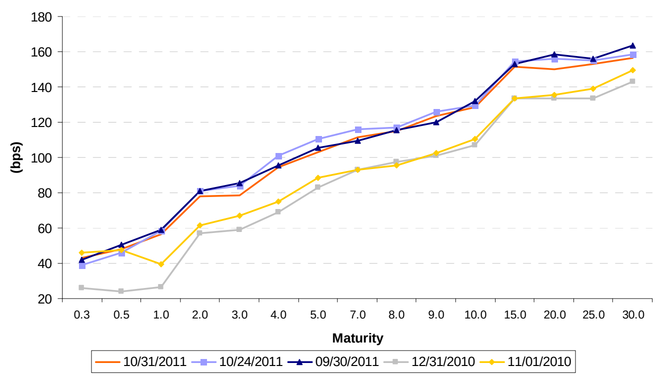
A Rated Utility Yield Curve & Spread to GoC



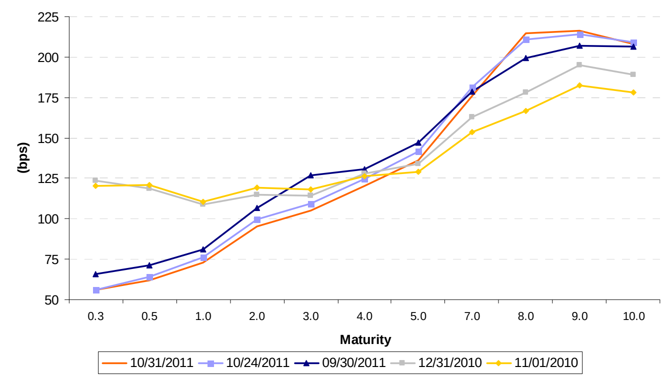

BBB Rated Utility Yield Curve & Spread to GoC



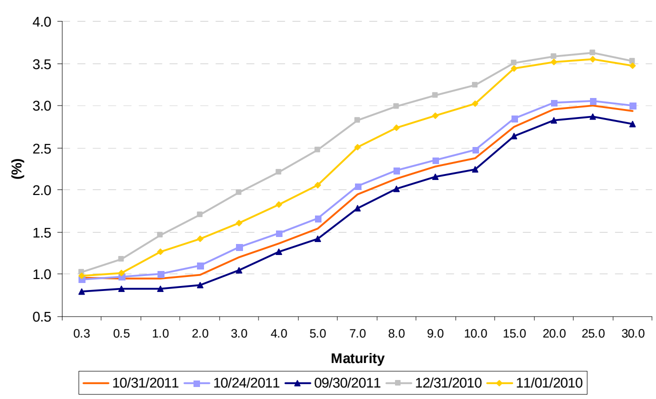

A Rated Utility Yield Curve



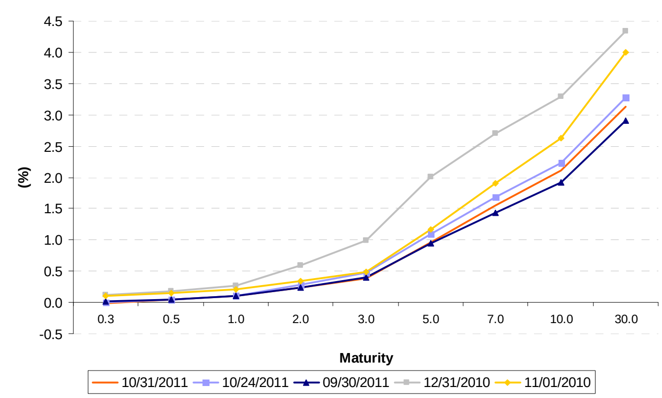

BBB Rated Utility Yield Curve




GoC Yield Curve




U.S. Yield Curve




| | 5 Yr GoC Yield (%) | 10 Yr GoC Yield (%) | 30 Yr GoC Yield (%) | 10 Yr A-Rated Utility Yield (%) | 20 Yr A-Rated Utility Yield (%) | 30 Yr A-Rated Utility Yield (%) | 5 Yr BBB-Rated Utility Yield (%) | 10 Yr BBB-Rated Utility Yield (%) | 10 Yr A-Rated Utility Spreads (bps) | 20 Yr A-Rated Utility Spreads (bps) | 30 Yr A-Rated Utility Spreads (bps) | 5 Yr BBB-Rated Utility Spreads (bps) | 10 Yr BBB-Rated Utility Spreads (bps) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Q1/11 | 0.28 | 0.25 | 0.24 | 0.25 | 0.21 | 0.19 | 0.13 | 0.12 | 0.38 | -1.91 | -4.41 | -15.70 | -12.92 |
| Q2/11 | -0.08 | -0.05 | 0.02 | 0.07 | 0.05 | 0.04 | -0.15 | -0.15 | 11.56 | 6.58 | 2.30 | -6.04 | -10.38 |
| Q3/11 | -1.15 | -1.08 | -0.82 | -0.84 | -0.60 | -0.64 | -0.99 | -0.86 | 24.37 | 23.38 | 18.70 | 15.57 | 21.38 |
| YTD | -0.92 | -0.86 | -0.59 | -0.64 | -0.46 | -0.45 | -0.90 | -0.67 | 21.67 | 16.47 | 13.54 | 2.10 | 19.20 |
| YoY | -0.51 | -0.65 | -0.53 | -0.47 | -0.41 | -0.46 | -0.44 | -0.35 | 18.03 | 14.56 | 7.01 | 7.12 | 29.71 |
| MoM | 0.13 | 0.13 | 0.16 | 0.10 | 0.05 | 0.09 | 0.02 | 0.15 | -3.30 | -8.31 | -7.06 | -10.75 | 1.65 |
| WoW | -0.11 | -0.09 | -0.06 | -0.10 | -0.14 | -0.08 | -0.17 | -0.11 | -0.91 | -6.02 | -2.01 | -5.34 | -1.32 |

Source: Bloomberg, RBC Capital Markets

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|---|---|---|---|---|
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| HOLD[SP] | 190 | 48.72 | 117 | 61.58 |
| SELL[U] | 72 | 18.46 | 29 | 40.28 |

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CREDIT | RESEARCH

COMPANY UPDATE | CANADIAN CREDIT COMMENT

FEBRUARY 10, 2012

# Fortis Inc.

## Q4/11: Another Record Capex Year Ahead

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform** |
| **FortisAlberta Inc.** | **Sector Perform** |
| **FortisBC Inc.** | **Sector Perform** |
| **FortisBC Energy Inc.** | **Sector Perform** |
| **FortisBC Energy (Van. Island) Inc.** | **Outperform** |
| **Newfoundland Power Inc.** | **Sector Perform** |

**Fortis reports Q4/11 (Credit Neutral):** Fortis reported Q4/11 normalized EPS of $0.46 compared to RBC and consensus estimates of $0.49 and $0.47. The variance was primarily driven by Caribbean Regulated Utilities and Properties. Overall, Canadian regulated utilities were largely in line with estimates. After accounting for capex and dividends, Fortis generated a Gross FCF deficit of $189MM (vs a deficit of $222MM in Q4/10) with new debt funding the gap. Key credit metrics were unchanged sequentially, ending the year with debt-to-EBITDA and EBITDA-to-interest of 4.9x and 3.3x, respectively (Exhibit 1).

**Dividend boosted:** In December 2011, Fortis announced a $0.01/share increase to its quarterly dividend to $0.30/share, representing an incremental increase in cash outlay of just under $2MM annually. Also during the quarter, the company's US$40MM convertible debentures were converted into 1.4MM common shares.

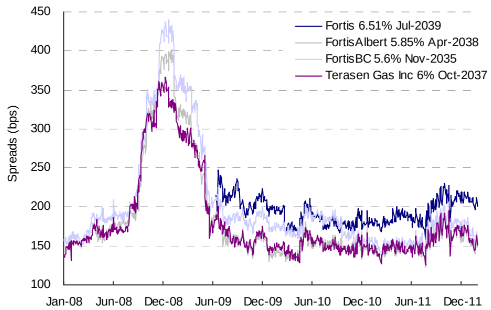
**Regulatory update:** In its December 2012 decision, the AUC pushed out its consideration for an automatic ROE adjustment formula for at least another year and lowered the allowed ROE for Alberta-based utilities (including FortisAlberta) to 8.75% for 2012, from 9.0% previously. Similarly, Newfoundland Power's regulator suspended the utility's automatic ROE adjustment formula, but retained its ROE at 8.38% for 2012, unchanged from 2011. These decisions are a direct reflection on the low government bond yield environment. We expect both provincial regulators to continue to assess automatic adjustment formulae for future rate years. In Alberta, the regulator is expected this year to decide on a 5-year performance based regulatory framework that could come into effect as early as 2013. The existing allowed ROEs for the FortisBC gas and electric utilities are to be maintained at 9.5% and 9.9%, respectively, pending the Generic Cost of Capital Proceeding expected to occur in early 2012.

**Heavy capex continues into 2012 and beyond:** Following a record capex of $1.2B in 2011, management is guiding towards another record year with $1.3B this year. Over the next five years, capex is expected to reach $5.5B.

**Approximately $500MM in external funding expected in 2012:** We think both FortisAlberta and FortisBC Energy Inc. will likely tap the debt capital markets again in 2012, each in the range of $100MM-$150MM. At the holding company level, Fortis Inc. may need to raise external capital in the order of $250MM-$300MM this year to fund projects such as the Waneta hydroelectric plant and equity injections down to its utility opcos.

**HoldCo bonds still looking attractive:** We continue to believe the discount on Fortis' HoldCo bonds versus its regulated OpCos provide good value. The healthy spread pick up of ~50bps (long duration bonds) to compensate for the structural subordination provides an attractive entry point, in our view, especially when considering the diversified and stable source of cash flows generated by its regulated utility subsidiaries. For investors concerned about a major acquisition, we believe management will remain disciplined (as it has been with past transaction) and will not lever up the balance sheet to complete an acquisition.

**Historical Spreads**




Source: ADI

**Fortis Inc. Credit Summary**

| **Cash Flow Summary ($MM)** | **2010** | **2011** | *2012E* | *2013E* |
|---|---|---|---|---|
| EBITDA | 1,150 | 1,185 | *1,325* | *1,404* |
| **FFO** | **734** | **806** | *849* | *898* |
| Capital expenditures | (1,073) | (1,174) | *(1,300)* | *(1,100)* |
| Dividends | (281) | (189) | *(234)* | *(242)* |
| **Gross FCF** | **(620)** | **(557)** | *(685)* | *(444)* |
| Changes in w/c | 49 | 98 | - | - |
| FCF after w/c | (571) | (459) | *(685)* | *(444)* |
| Acquisitions | - | - | - | - |
| Other investing | 82 | 49 | - | - |
| **FCF before financing** | **(489)** | **(410)** | *(685)* | *(444)* |
| Debt issuance/(repay.) | 146 | (36) | *532* | *344* |
| Common issuance | 80 | 345 | *64* | *100* |
| Preferred issuance | 242 | - | - | - |
| Other financing | 45 | 81 | - | - |
| **Net change in cash** | **24** | **(20)** | *(89)* | - |
| **Capital Structure ($MM)** | | | | |
| Total debt | 6,023 | 5,944 | *6,476* | *6,820* |
| Non-controlling int. | 162 | 208 | *208* | *208* |
| Preference Shares | 912 | 912 | *912* | *912* |
| Shareholders' equity | 3,305 | 3,877 | *4,189* | *4,552* |
| **Total capital** | **10,402** | **10,941** | *11,785* | *12,492* |
| Cash and equivalents | 109 | 89 | - | - |
| **Credit Ratios** | | | | |
| Adjusted Debt / Capital[1] | 62% | 58% | *59%* | *58%* |
| Net Adj. Debt / Capital[1] | 62% | 58% | *59%* | *58%* |
| EBITDA / interest | 3.2x | 3.2x | *3.6x* | *3.6x* |
| EBIT / interest | 2.0x | 2.1x | *2.5x* | *2.5x* |
| Total Debt / EBITDA | 5.2x | 5.0x | *4.9x* | *4.9x* |
| FFO / Total Debt | 12.2% | 13.6% | *13.1%* | *13.2%* |
| **Credit Ratios** | | **DBRS** | **S&P** | ***Moody's*** |
| Rating | | A(L) | A- | NR |
| Outlook | | Stable | Stable | - |

1. 50% equity and 50% debt treatment to pref. shares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All values in Canadian dollar unless otherwise noted.

**Priced as of prior trading day's market close, EST (unless otherwise noted).**

**For Required Conflicts Disclosures, please see Page 8.**

## Highlights

**FortisAlberta's ROE lowered with Generic Cost of Capital decision in Alberta:** On December 8, 2011, the Alberta Utilities Commission (AUC) released its Generic Cost of Capital (GCoC) decision, where the AUC: (i) reduced the allowed ROE for Alberta based utilities to 8.75% (from 9.0% previously) for 2012 and on an interim basis for 2013; and (ii) decided that it would not introduce a formula to automatically adjust allowed ROEs on an annual basis. The decision to reduce the ROE was applied retroactively to Q4/11, negatively impacting FortisAlberta's earnings by $2MM. As part of the process to finalize the 2013 ROE, the AUC noted that it would re-examine the potential to bring back a formula-based automatic adjustment mechanism. FortisAlberta filed a performance-based regulation ("PBR") proposal in July 2011, based on an AUC initiative to apply PBR as early as 2013 for a 5-year term.

**Suspension of automatic adjustment formula for Newfoundland Power:** On December 14, 2011, the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB) approved the suspension of the automatic adjustment formula used to set Newfoundland Power's rate of return on its 2012 rate base. As a result of the suspension, Newfoundland Power's ROE remains at 8.38% with customer rates unchanged in 2012. This is a modest credit positive, in our view, as the ROE would have been much lower given the formula's linkage to the forecast of long-term Canada bond yields, which are near record lows. A full cost of capital review is expected to be held by the PUB in 2012.

**Application filed to amalgamate BC gas utilities:** Fortis filed an application with the BCUC in November 2011 to amalgamate its three BC-based gas utilities. The application was subsequently suspended by the utilities to provide additional information to BCUC. Pending approval from BCUC and consent from the BC government, the amalgamation will become effective January 1, 2013. If approved, the three utilities would form one legal entity and bonds issued by FortisBC Energy (FBCE) and FortisBC Energy (Vancouver Island) (FBCV) Inc. would rank parri-passu. Our Outperform rating on FBCV is based on the view that the spreads would tighten to trade in-line with FBCE bonds following the amalgamation.

**Belize Update:** The Government of Belize's independent valuation of Belize Electricity Ltd. (booked as a LT other asset totaling $106MM at the end of 2011) came in 'significantly lower' than the fair value determined by Fortis' independent valuator. The company is currently pursuing alternatives to obtain fair compensation from the government. For fixed income investors, we believe the outcome of the claim to be immaterial as the asset has contributed minimal earnings since 2008. With respect to the non-regulated hydroelectric generation assets in Belize, the Government of Belize has indicated that it does not plan to expropriate these assets.

**A busy Q4 in the debt capital markets:** During the quarter, four of Fortis' regulated utility subsidiaries issued a total of $307MM debt: (i) FortisAlberta issued $125MM 4.54% due 10/18/2041 at 158 bps; (ii) Maritime Electric issued $30MM 4.915% due 12/05/2061 at 220 bps; (iii) FortisBC Energy Inc. issued $100MM 4.25% due 12/09/2041 at 163 bps; and (iv) FortisOntario issued a $52MM 5.118% with a 30-year maturity. Proceeds from these debt offerings were mainly used to repay credit facility borrowings incurred to fund capex. In total, $688MM of capital was raised in 2011, including $341MM of common equity, with proceeds used to repay credit facility borrowings and inject equity into the regulated utilities in western Canada and the non-regulated Waneta Expansion project.

**Work continues on Waneta Expansion:** The 335MW hydroelectric project in BC is currently running on schedule and is projected to be in service in the spring of 2015 at an estimated cost of $900MM. To date, $244MM has been spent. The non-regulated asset will sell energy and capacity to BC Hydro and FortisBC Electric under a 40-year power sales contract.

**Adequate liquidity:** At the end of Q4/11, Fortis Inc and its subsidiaries had $89MM of cash on its book and $1.9B available under its $2.2B credit facilities. We believe the current liquidity is adequate to meet near-term funding requirements.

## Outlook and Funding Expectations

**Five-year capital program of $5.5B:** Fortis has guided towards a five-year (out to 2016) capital spending program of $5.5B, which the company expects will be funded mainly at the subsidiary level. The company projects its consolidated rate base will reach $10.3B in 2016, compared to $8.1B in 2011, for a CAGR of approximately 5%. Under the plan, regulated electric utilities, including FortisAlberta and FortisBC Electric, will receive the bulk of the investment with 64%, followed by regulated gas utilities (23%) and non-regulated operations (13%).

**Funding expectations:** Fortis' utility subsidiaries (mainly FortisAlberta) will continue to require equity from Fortis in order to maintain regulated capital structures as these utilities grow their rate base. Fortis raises funds through a combination of debt, common equity, and preferred equity, such that consolidated leverage remains near 60%. Fortis' utility subsidiaries issue public debt in their own names, with proceeds used to fund capital spending and refinance debt maturities. There is only one small $15MM maturity at FortisBC in 2012 (Exhibit 5), hence new issuance this year will essentially be for the purpose of funding capex.

- **Fortis Inc.:** Fortis Inc. may need to raise external capital in the order of $250MM-$300MM this year to fund projects such as the Waneta hydroelectric plant and equity injections down to its utility opcos. Over the next few years, we expect capital funding to be a mix of debt and equity (common and prefs) to maintain consolidated debt in its capital structure below 60%.
- **FortisBC Energy:** In 2012, we think FortisBC Energy will need to borrow in the range of $100MM-$150MM and would require a $25-$30MM equity injection to fund capex (guidance of $244MM the FortisBC Energy group of companies) and dividends to it parent. FortisBC Energy had ~$65MM outstanding on its credit facility at the end of 2011. In 2011, FortisBC Energy issued $100MM in long-term debt and did not receive an equity injection.

- **FortisAlberta:** In 2011, the utility received $55MM in equity injections from its parent and issued $125MM in long term debt (noted above) to help fund $405MM in capex. FortisAlberta had $30MM drawn on its credit facilities at the end of 2011. For 2012, our estimate is that FortisAlberta could issue another $100MM-$150MM in debt in the latter part of the year and receive another $50MM-$60MM equity injection to fund capital spending ($419MM) and maintain its regulated capital structure.
- **FortisBC:** FortisBC last issued debt in 2010 ($100MM) and received a $10MM equity injection from Fortis Inc. that year. In 2011, FortisBC did not issue long-term debt or receive an equity injection from its parent, as the utility's capital program was funded with cash flow and $15MM in short term borrowing. We think FortisBC's borrowing requirements in 2012 will be minimal, as we estimate that the majority of its $111MM capex budget this year will be funded with FFO. We estimate the utility could draw in the order of $35MM on its credit facility this year. We also think equity contributions over the next couple of years will not be required.
- **Newfoundland Power:** We expect Newfoundland Power to fund the majority of its $82MM 2012 capital program with cash flow and a minimal amount of short-term borrowing. The last time we saw this utility issue debt was in 2007.

**Exhibit 1: Fortis Inc. Historical Consolidated Financials and Forecasts**

| Fortis Inc. | | | | | | | | *Forecast* | |
|---|---|---|---|---|---|---|---|---|---|
| **Consolidated ($ millions)** | **2010** | **2011** | **Q4/10** | **Q1/11** | **Q2/11** | **Q3/11** | **Q4/11** | *2012E* | *2013E* |
| **Earnings Summary** | | | | | | | | | |
| EBITDA | 1,150 | 1,185 | 301 | 348 | 279 | 273 | 310 | *1,325* | *1,404* |
| EBIT | 740 | 766 | 198 | 245 | 176 | 168 | 202 | *940* | *983* |
| Gross interest | 361 | 370 | 90 | 94 | 93 | 92 | 90 | *372* | *387* |
| **Cash Flow Summary** | | | | | | | | | |
| **FFO** | 734 | 806 | 209 | 242 | 180 | 154 | 231 | *849* | *898* |
| Capital Expenditures | (1,073) | (1,174) | (370) | (233) | (286) | (287) | (368) | *(1,300)* | *(1,100)* |
| Preferred dividends | (28) | (29) | (7) | (7) | (8) | (7) | (7) | *(28)* | *(28)* |
| Dividends (common & non-cont.) | (253) | (160) | (54) | (53) | (38) | (40) | (45) | *(206)* | *(214)* |
| **Gross free cash flow (FCF)** | **(620)** | **(557)** | **(222)** | **(51)** | **(152)** | **(180)** | **(189)** | *(685)* | *(444)* |
| Changes in working capital | 49 | 98 | (8) | 57 | 48 | (3) | (4) | - | - |
| Gross FCF after working capital | (571) | (459) | (230) | 6 | (104) | (183) | (193) | *(685)* | *(444)* |
| Divestitures / Acquisitions | | | | | | | | - | - |
| Other investing activities | 82 | 49 | 37 | 14 | 18 | 18 | (1) | - | - |
| **Free cash flow before financing** | **(489)** | **(410)** | **(193)** | **20** | **(86)** | **(165)** | **(194)** | *(685)* | *(444)* |
| Debt drawn/(repaid) | 146 | (36) | 172 | (87) | (32) | (86) | 168 | *532* | *344* |
| Issue of common shares[1] | 80 | 345 | 22 | 27 | 290 | 40 | 4 | *64* | *100* |
| Issue of preference shares | 242 | - | - | - | - | - | - | - | - |
| Other financing activities | 45 | 81 | 44 | 17 | 40 | 20 | 4 | - | - |
| F/X gain/(loss) | - | - | - | - | - | 1 | (1) | - | - |
| **Net increase (decrease) in cash** | **24** | **(20)** | **45** | **(23)** | **212** | **(190)** | **(19)** | *(89.0)* | - |
| **Capital Structure** | | | | | | | | | |
| Total debt | 6,023 | 5,944 | 6,023 | 5,915 | 5,857 | 5,837 | 5,944 | *6,476* | *6,820* |
| Non-controlling interest | 162 | 208 | 162 | 175 | 178 | 205 | 208 | *208* | *208* |
| Preference Shares | 912 | 912 | 912 | 912 | 912 | 912 | 912 | *912* | *912* |
| Shareholders' equity | 3,305 | 3,877 | 3,305 | 3,397 | 3,738 | 3,809 | 3,877 | *4,189* | *4,552* |
| **Total capital** | **10,402** | **10,941** | **10,402** | **10,399** | **10,685** | **10,763** | **10,941** | **11,785** | **12,492** |
| Cash and equivalents | 109 | 89 | 109 | 86 | 298 | 108 | 89 | - | - |
| **Credit Ratios[2]** | | | | | | | | | |
| Total Debt / Capital | 57.9% | 54.3% | 57.9% | 56.9% | 54.8% | 54.2% | 54.3% | *54.9%* | *54.6%* |
| Adjusted Debt / Capital[2] | 62.3% | 58.5% | 62.3% | 61.3% | 59.1% | 58.5% | 58.5% | *58.8%* | *58.2%* |
| Net Debt / Capital | 57.5% | 54.0% | 57.5% | 56.5% | 53.5% | 53.8% | 54.0% | *54.9%* | *54.6%* |
| Net Adjusted Debt / Capital[2] | 61.9% | 58.2% | 61.9% | 60.9% | 57.9% | 58.0% | 58.2% | *58.8%* | *58.2%* |
| (FFO + interest) / interest | 3.0x | 3.2x | 3.0x | 3.1x | 3.2x | 3.1x | 3.2x | *3.3x* | *3.3x* |
| EBITDA / interest | 3.2x | 3.2x | 3.2x | 3.2x | 3.2x | 3.3x | 3.3x | *3.6x* | *3.6x* |
| EBIT / interest | 2.0x | 2.1x | 2.0x | 2.1x | 2.1x | 2.1x | 2.1x | *2.5x* | *2.5x* |
| Total Debt / EBITDA | 5.2x | 5.0x | 5.2x | 5.0x | 4.9x | 4.9x | 4.9x | *4.9* | *4.9* |
| FFO / Total Debt | 12.2% | 13.6% | 12.3% | 13.1% | 13.6% | 13.4% | 13.6% | *13.1%* | *13.2%* |

1. Issue of common shares includes the company's DRIP.
2. Adjusted leverage ratios incorporate a 50%/50% debt/equity treatment for preferred equity.

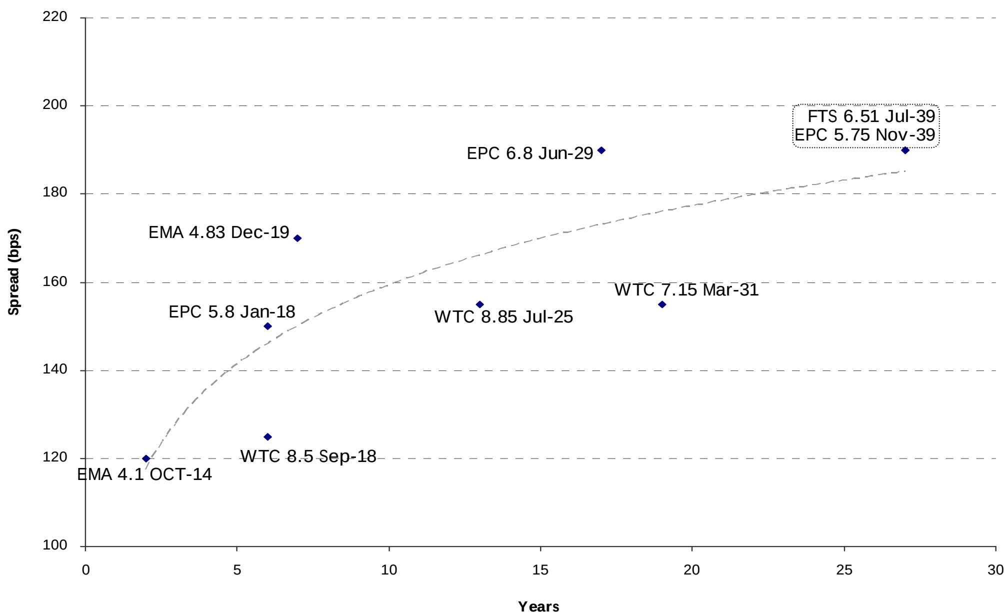
Source: Company reports, RBC Capital Markets estimates

## Exhibit 2: Capital Spending by Subsidiary ($ millions)

| | FortisBC Energy Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| **2011** | 253 | 416 | 102 | 81 | 47 | **899** | 71 | 174 | 30 | **1,174** |
| **2012F** | 244 | 419 | 111 | 82 | 61 | **917** | 55 | 256 | 63 | **1,291** |

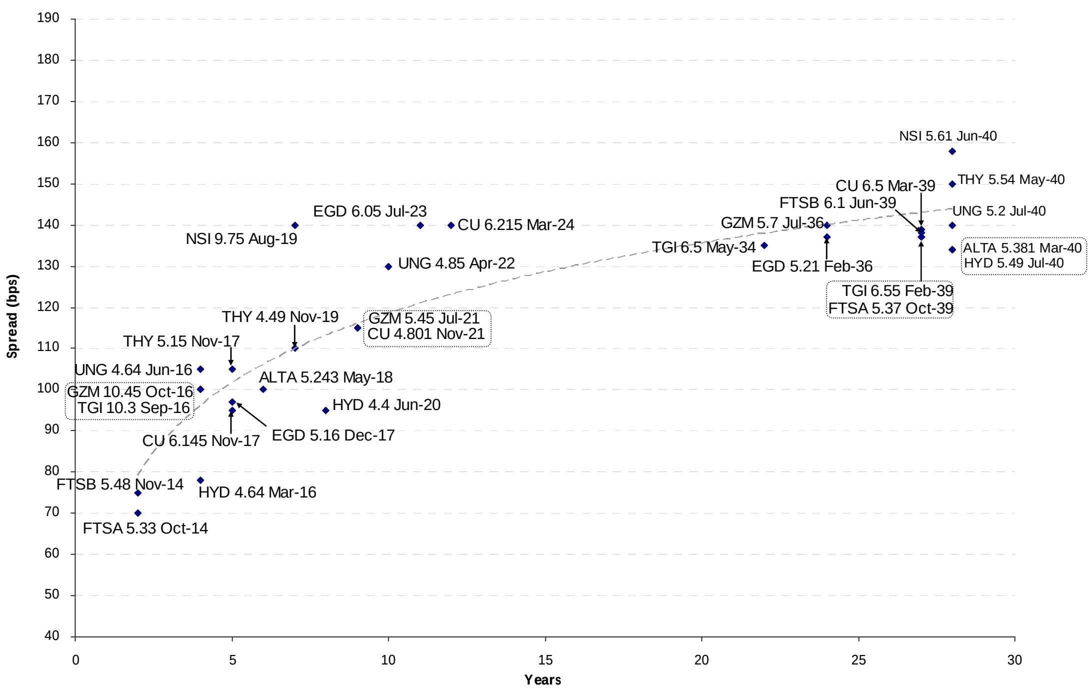
Source: Company reports

## Exhibit 3: Relative Value Chart – Canadian Utility Holding Companies




Source: RBC Capital Markets

## Exhibit 4: Relative Value Chart – Canadian Regulated Utilities




Source: RBC Capital Markets

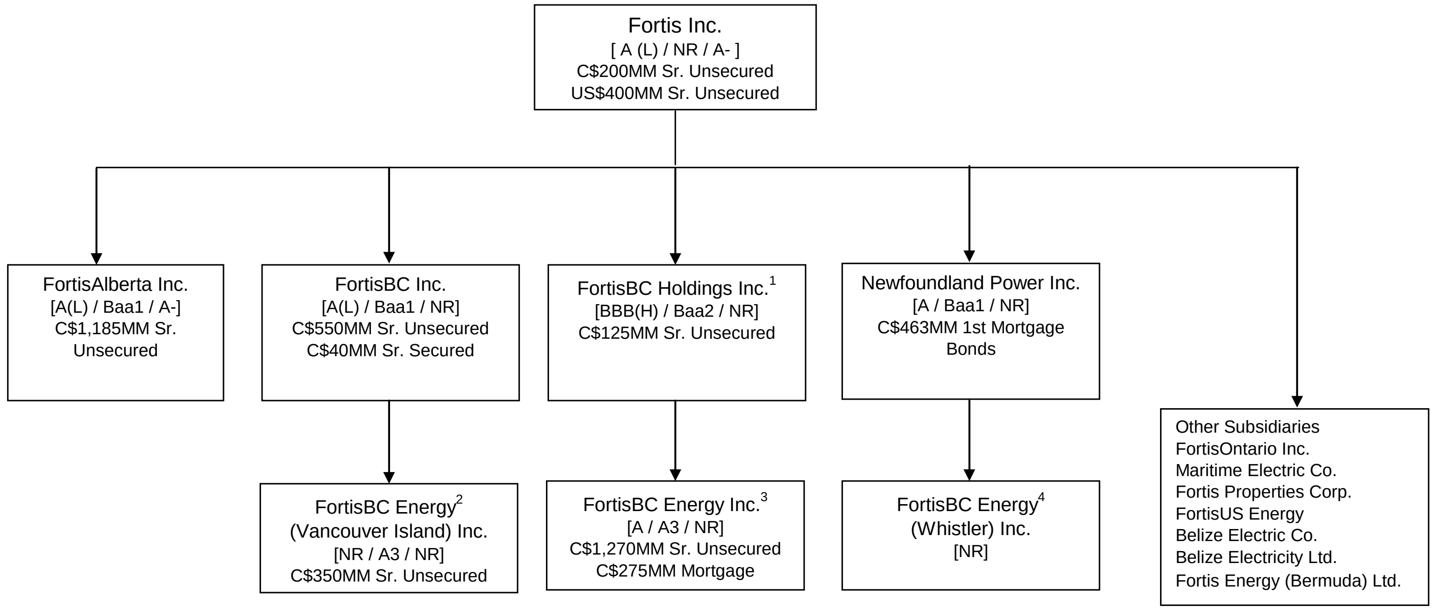
### Exhibit 5: Fortis Inc. and Major Subsidiary Bonds Outstanding

| Issuer Name | Amount ($MM) | Currency | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Fortis Inc. | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | USD | 6.60% | 09/01/2037 | 09/6/2007 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc. | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **600** | | | | | | |
| **FortisBC Holdings** | **125** | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| BC Gas Utility[1,2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[1,2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[1,2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| FortisBC Energy Inc. | 100 | CAD | 4.25% | 12/09/2041 | 12/06/2011 | Call +41 bps | Senior Unsecured |
| **FortisBC Energy Inc.** | **1,545** | | | | | | |
| **FortisBC Energy (Van) Inc.** | **350** | | | | | | |
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.54% | 10/18/2041 | 10/14/2011 | Call +39.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,185** | | | | | | |
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |
| Newfoundland Light & Power | 30 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 32 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 34 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 34 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 44 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 68 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 56 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 67 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 64 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **463** | | | | | | |
| **Total Bonds Outstanding** | **4,858** | | | | | | |

(1) Terasen Gas Inc. was formerly called BC Gas Utility.
(2) Terasen Gas Inc. has been renamed as FortisBC Energy Inc.
(3) Terasen Gas (Vancouver Island) Inc. has been renamed as FortisBC Energy (Vancouver Island) Inc.

Source: Bloomberg, Company reports, RBC Capital Markets Research

**Exhibit 6: Simplified Organizational Structure**




1. FortisBC Holdings Inc. formerly known as Terasen Inc.
2. FortisBC Energy (Vancouver Island) Inc. formerly known as Terasen Gas (Vancouver Island) Inc.
3. FortisBC Energy Inc. formerly known as Terasen Gas Inc.
4. FortisBC Energy (Whistler) Inc. formerly known as Terasen Gas (Whistler) Inc.

Source: Bloomberg, Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service Holdco debt. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of the member companies of RBC Capital Markets and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets and its affiliates.

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RBC Capital Markets has provided Fortis Inc. with non-securities services in the past 12 months.

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**Top Pick (TP):** Represents the analyst’s best ideas in the Outperform category; provides best relative risk-reward ratio and/or is expected to significantly outperform the sector over 12 months.

**Outperform (O):** Provides superior relative risk-reward ratio and/or is expected to materially outperform the sector average over 12 months.

**Sector Perform (SP):** Provides an adequate relative risk-reward ratio and/or total return is expected to be in line with the sector average over 12 months.

**Underperform (U):** Provides an inferior relative risk-reward ratio and/or total return is expected to be materially below the sector average over 12 months.

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**Distribution of Ratings**
**RBC Capital Markets, Credit Research**

| | | | Investment Banking Serv./Past 12 Mos. | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| BUY[TP/O] | 102 | 35.54 | 74 | 72.55 |
| HOLD[SP] | 138 | 48.08 | 109 | 78.99 |
| SELL[U] | 47 | 16.38 | 25 | 53.19 |

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COMPANY UPDATE | **CANADIAN CREDIT COMMENT**

**MAY 3, 2012**

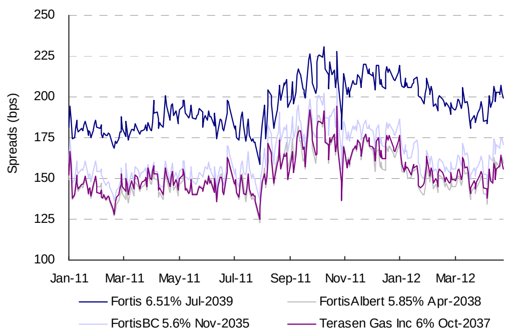
# Fortis Inc.

## Q1/12: In-line Results, Capital Spending Plan Maintained

| | |
|---|---|
| **Fortis Inc.** | **Sector Perform*** |
| **FortisAlberta Inc.** | **Sector Perform*** |
| **FortisBC Inc.** | **Sector Perform*** |
| **FortisBC Energy Inc.** | **Sector Perform*** |
| **FortisBC Energy (Van. Island) Inc.** | **Outperform*** |
| **Newfoundland Power Inc.** | **Sector Perform*** |

*Investment rankings on CAD debt

**Historical Spreads**




Source: ADI

**Fortis Inc. Credit Summary**

| **Cash Flow Summary ($MM)** | **2010** | **2011** | *2012E* |
|---|---|---|---|
| EBITDA | 1,150 | 1,185 | *1,325* |
| **FFO** | **734** | **806** | *849* |
| Capital expenditures | (1,073) | (1,174) | *(1,300)* |
| Dividends | (281) | (189) | *(234)* |
| **Gross FCF** | **(620)** | **(557)** | *(685)* |
| Changes in w/c | 49 | 98 | - |
| FCF after w/c | (571) | (459) | *(685)* |
| Acquisitions | - | (25) | - |
| Other investing | 82 | 74 | - |
| **FCF before financing** | **(489)** | **(410)** | *(685)* |
| Debt issuance/(repay.) | 146 | (36) | *532* |
| Common issuance | 80 | 345 | *64* |
| Preferred issuance | 242 | - | - |
| Other financing | 45 | 81 | - |
| **Net change in cash** | **24** | **(20)** | *(89)* |
| **Capital Structure ($MM)** | | | |
| Total debt | 6,023 | 5,944 | *6,476* |
| Non-controlling int. | 162 | 208 | *208* |
| Preference Shares | 912 | 912 | *912* |
| Shareholders' equity | 3,305 | 3,877 | *4,189* |
| **Total capital** | **10,402** | **10,941** | *11,785* |
| Cash and equivalents | 109 | 89 | - |
| **Credit Ratios** | | | |
| Adjusted Debt / Capital[1] | 62% | 58% | *59%* |
| Net Adj. Debt / Capital[1] | 62% | 58% | *59%* |
| EBITDA / interest | 3.2x | 3.2x | *3.6x* |
| EBIT / interest | 2.0x | 2.1x | *2.5x* |
| Total Debt / EBITDA | 5.2x | 5.0x | *4.9x* |
| FFO / Total Debt | 12.2% | 13.6% | *13.1%* |
| **Credit Ratios** | **DBRS** | **S&P** | ***Moody's*** |
| Rating | A(L) | A- | NR |
| Outlook | U/R Dev. | CW-neg | - |

1. 50% equity and 50% debt treatment to pref. shares

Source: RBC Capital Markets estimates, Company reports, Rating agencies

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All values in Canadian dollar unless otherwise noted.

**Fortis reports Q1/12 (credit neutral):** Fortis reported Q1/12 normalized EPS of $0.66, in-line with RBC's estimate of $0.65 and $0.66 a year ago (adjusted for US GAAP conversion). Fortis generated a gross FCF deficit of $37MM after capex and dividends (vs. a deficit of $51MM in Q1/11). The shortfall was essentially funded by a positive swing in working capital. Key credit metrics were unchanged sequentially, with EBITDA-to-interest and debt-to-EBITDA of 3.3x and 5.1x, respectively (Exhibit 1). In our view, the key near-term credit driver for Fortis is the pending CH Energy acquisition that was announced in February 2012.

**Capex budget maintained:** Fortis has maintained its $1.3Bln capital spending budget for this year, and $5.5Bln over the five-year period 2012-2016.

**Approximately $500MM in external funding expected in 2012:** We think both FortisAlberta and FortisBC Energy Inc. will likely tap the debt capital markets again in 2012, each in the range of $100MM-$150MM. At the holding company level, Fortis Inc. may need to raise external capital in the order of $250MM-$300MM this year to fund projects such as the Waneta hydroelectric plant and equity injections down to its utility opcos. For more details on 2012 capital requirements by issuer, see our report on Fortis Q4/11 dated Feb. 10, 2012.

**CH Energy acquisition expected to close by end of Q1/13:** Fortis agreed to acquire CH Energy for approximately US$1.5Bln, including the assumption of about US$500MM of debt. Management indicated to us that the remaining US$1.0Bln will likely be funded with: (i) ~$500MM in common equity, (ii) $100MM to $150MM of preferreds, and (iii) USD 10-year holdco debt for the balance. Funding for the transaction will be premised on maintaining "A(low)/A-" level credit ratings. See Exhibit 3 for our estimate of the impact of the transaction on credit metrics. Fortis expects the transaction to close by the end of Q1/13.

**Maintaining "A-" level credit ratings:** In response to the transaction, S&P placed Fortis' "A-" rating on Credit Watch Negative, and DBRS placed its A(low) rating Under Review Developing. S&P pointed to concerns over increased holdco debt as a key ratings consideration, with a focus on consolidated adjusted FFO-to-debt remaining above 10% and company level debt coverage from subsidiary cash flow of at least 20%. In our conversations with S&P, the analysts also expressed concern beyond the CH Energy acquisition and the potential for a longer term trend of growing holdco debt as Fortis expands US operations further. DBRS would like to see Fortis' non-consolidated FFO-to-capital remain below 20% (currently 14%), which DBRS says is the upper threshold for an A(low) rating.

**HoldCo bonds offer attractive pick-up:** We believe the ~35bps discount on Fortis' HoldCo bonds versus its regulated OpCos provides good value. In our view the structural subordination at the Holdco level is offset by the well-diversified and stable source of cash flows generated by its regulated utility subsidiaries. With respect to acquisitions, we believe management will remain disciplined (as it has been with past transactions) in terms of the capital structure.

**Priced as of prior trading day's market close, ET (unless otherwise noted).**

**For Required Conflicts Disclosures, please see Page 8.**

**Exhibit 1: Fortis Inc. Historical Consolidated Financials and Forecasts**

| Fortis Inc. Consolidated ($ millions) | 2010 | 2011 | Q1/11 | Q2/11 | Q3/11 | Q4/11 | Q1/12 | *2012E* |
|---|---|---|---|---|---|---|---|---|
| **Earnings Summary** | | | | | | | | |
| EBITDA | 1,150 | 1,185 | 348 | 279 | 273 | 310 | 369 | *1,325* |
| EBIT | 740 | 766 | 245 | 176 | 168 | 202 | 250 | *940* |
| Gross interest | 361 | 372 | 94 | 93 | 92 | 93 | 95 | *372* |
| **Cash Flow Summary** | | | | | | | | |
| **FFO** | 734 | 806 | 242 | 180 | 154 | 231 | 249 | *849* |
| Capital Expenditures | (1,073) | (1,174) | (233) | (286) | (287) | (368) | (229) | *(1,300)* |
| Preferred dividends | (28) | (29) | (7) | (8) | (7) | (7) | (11) | *(28)* |
| Dividends (common & non-cont.) | (253) | (160) | (53) | (38) | (40) | (45) | (46) | *(206)* |
| **Gross free cash flow (FCF)** | **(620)** | **(557)** | **(51)** | **(152)** | **(180)** | **(189)** | **(37)** | *(685)* |
| Changes in working capital | 49 | 98 | 57 | 48 | (3) | (4) | 79 | - |
| Gross FCF after working capital | (571) | (459) | 6 | (104) | (183) | (193) | 42 | *(685)* |
| Divestitures / Acquisitions | - | (25) | - | - | - | (25) | - | - |
| Other investing activities | 82 | 74 | 14 | 18 | 18 | 24 | 18 | - |
| **Free cash flow before financing** | **(489)** | **(410)** | **20** | **(86)** | **(165)** | **(194)** | **60** | *(685)* |
| Debt drawn/(repaid) | 146 | (36) | (87) | (32) | (86) | 168 | (80) | *532* |
| Issue of common shares[1] | 80 | 345 | 27 | 290 | 40 | 4 | 2 | *64* |
| Issue of preference shares | 242 | - | - | - | - | - | - | - |
| Advances from non-controlling | 45 | 81 | 17 | 40 | 20 | 4 | 41 | - |
| F/X gain/(loss) | - | - | - | - | 1 | (1) | - | - |
| **Net increase (decrease) in cash** | **24** | **(20)** | **(23)** | **212** | **(190)** | **(19)** | **23** | *(89.0)* |
| **Capital Structure** | | | | | | | | |
| Total debt | 6,023 | 5,944 | 5,915 | 5,857 | 5,837 | 5,944 | 6,296 | *6,476* |
| Non-controlling interest | 162 | 208 | 175 | 178 | 205 | 208 | 246 | *208* |
| Preference Shares | 912 | 912 | 912 | 912 | 912 | 912 | 912 | *912* |
| Shareholders' equity | 3,305 | 3,877 | 3,397 | 3,738 | 3,809 | 3,877 | 3,901 | *4,189* |
| **Total capital** | **10,402** | **10,941** | **10,399** | **10,685** | **10,763** | **10,941** | **11,355** | **11,785** |
| Cash and equivalents | 109 | 89 | 86 | 298 | 108 | 89 | 110 | - |
| **Credit Ratios[2]** | | | | | | | | |
| Total Debt / Capital | 57.9% | 54.3% | 56.9% | 54.8% | 54.2% | 54.3% | 55.4% | *54.9%* |
| Adjusted Debt / Capital[2] | 62.3% | 58.5% | 61.3% | 59.1% | 58.5% | 58.5% | 59.5% | *58.8%* |
| Net Debt / Capital | 57.5% | 54.0% | 56.5% | 53.5% | 53.8% | 54.0% | 55.0% | *54.9%* |
| Net Adjusted Debt / Capital[2] | 61.9% | 58.2% | 60.9% | 57.9% | 58.0% | 58.2% | 59.1% | *58.8%* |
| (FFO + interest) / interest | 3.0x | 3.2x | 3.1x | 3.2x | 3.1x | 3.2x | 3.2x | *3.3x* |
| EBITDA / interest | 3.2x | 3.2x | 3.2x | 3.2x | 3.3x | 3.3x | 3.3x | *3.6x* |
| EBIT / interest | 2.0x | 2.1x | 2.1x | 2.1x | 2.1x | 2.1x | 2.1x | *2.5x* |
| Total Debt / EBITDA | 5.2x | 5.0x | 5.0x | 4.9x | 4.9x | 5.0x | 5.1x | *4.9* |
| FFO / Total Debt | 12.2% | 13.6% | 13.1% | 13.6% | 13.4% | 13.6% | 12.9% | *13.1%* |

1. Issue of common shares includes the company's DRIP.
2. Adjusted leverage ratios incorporate a 50%/50% debt/equity treatment for preferred equity.

Source: Company reports, RBC Capital Markets estimates

**Exhibit 2: Capital Spending by Subsidiary ($ millions)**

| | FortisBC Energy Companies | FortisAlberta | FortisBC | Newfoundland Power | Other Reglated Electric Utilities - Canada | **Total Regulated Utilities - Canada** | Regulated Utilities - Caribbean | Non-Regulated - Utility | Fortis Properties | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|
| **2011** | 253 | 416 | 102 | 81 | 47 | **899** | 71 | 174 | 30 | **1,174** |
| **2012F** | 244 | 419 | 111 | 82 | 61 | **917** | 55 | 256 | 63 | **1,291** |

Source: Company reports

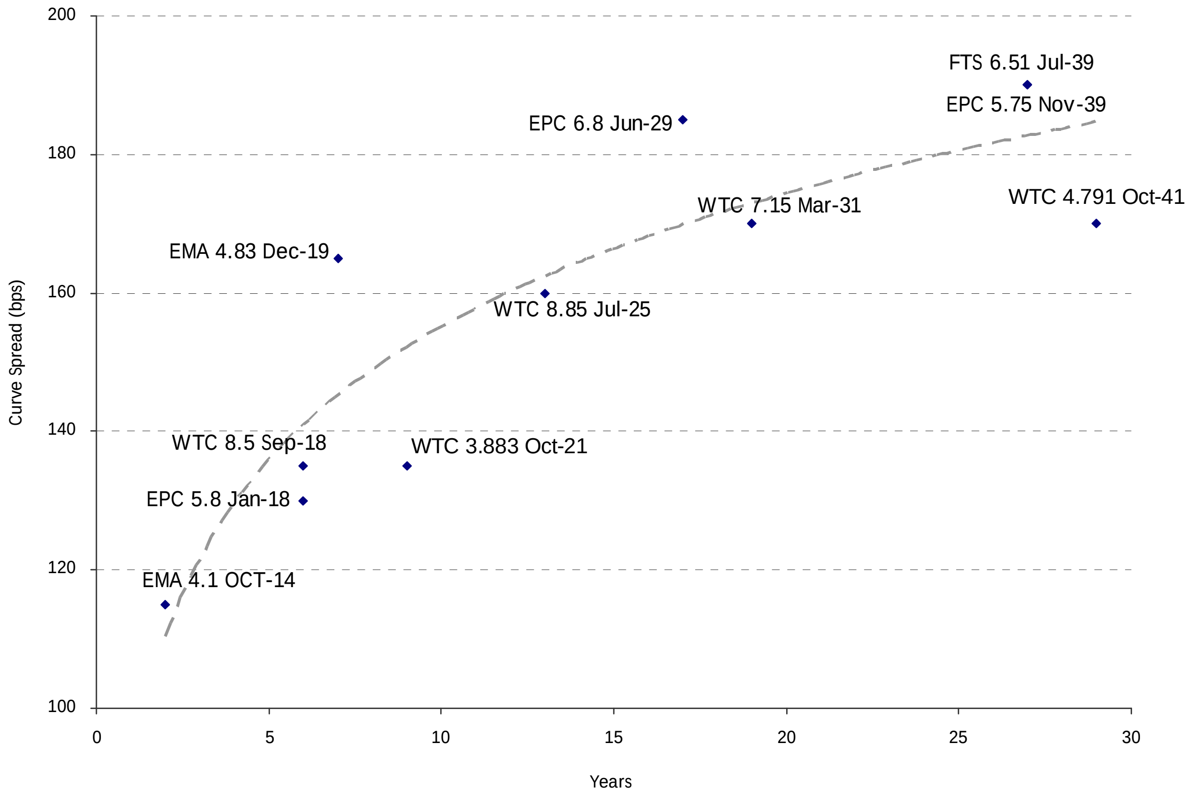
**Exhibit 3: CH Energy Acquisition**

| **CHE Acquisition** | **Fortis*** | **CH*** | **Post** |
|---|---|---|---|
| Total debt | 5,944 | 850 | *6,794* |
| Non-controlling interest | 208 | - | *208* |
| Preference Shares | 912 | 150 | *1,062* |
| Shareholders' equity | 3,877 | 500 | *4,377* |
| Total capital | 10,941 | 1,500 | *12,441* |
| | | | |
| EBITDA | 1,185 | 141 | *1,326* |
| FFO | 806 | 120 | *926* |
| | | | |
| Total Debt / Capital | 54.3% | 56.7% | *54.6%* |
| Adjusted Debt / Capital | 58.5% | 61.7% | *58.9%* |
| FFO/Debt | 13.6% | 14.1% | *13.6%* |
| Debt/EBITDA | 5.0x | 6.0x | *5.1x* |

*2011 financials

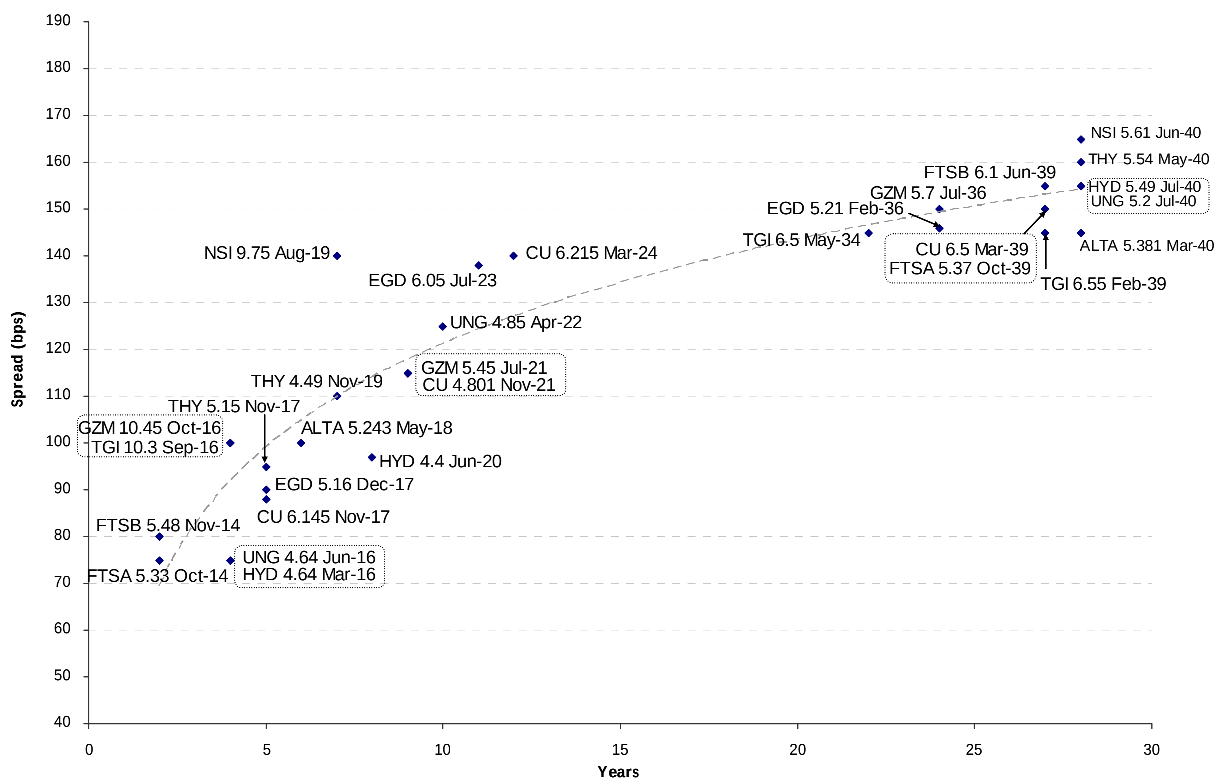
Source: RBC Capital Markets estimates, Bloomberg

**Exhibit 4: Relative Value Chart - Canadian Utility Holding Companies**




Source: RBC Capital Markets

**Exhibit 5: Relative Value Chart - Canadian Regulated Utilities**




Source: RBC Capital Markets

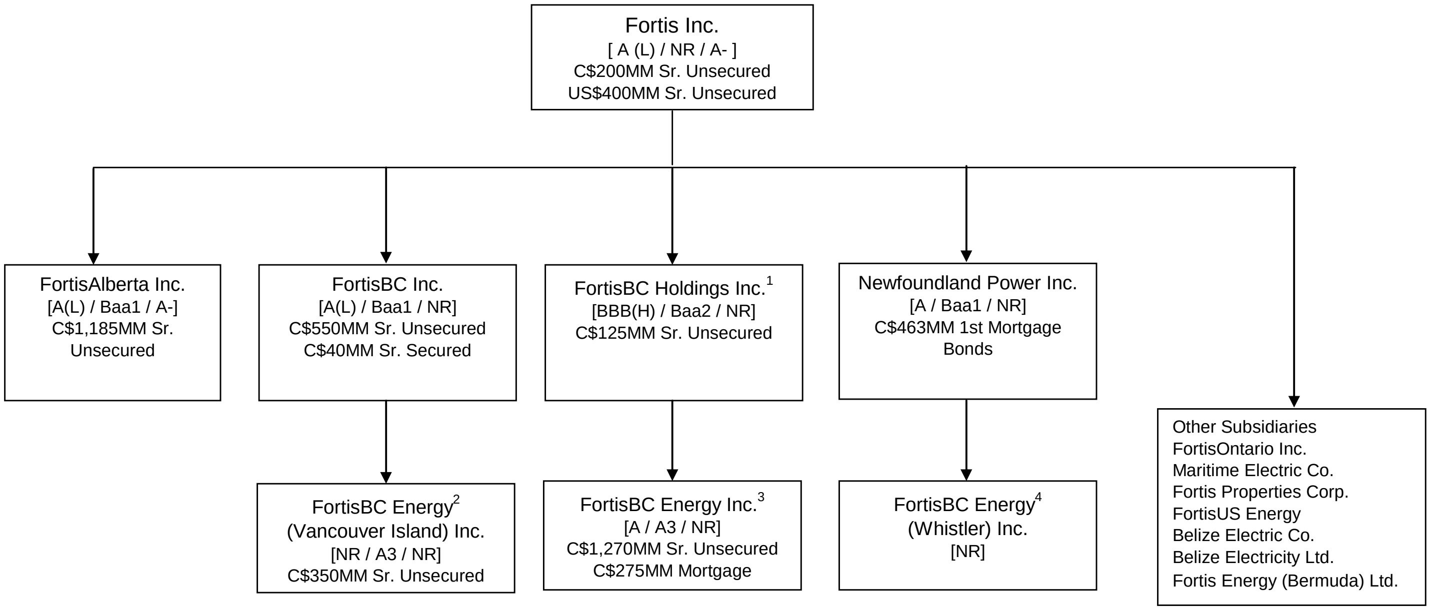
**Exhibit 6: Fortis Inc. and Major Subsidiary Bonds Outstanding**

| Issuer Name | Amount ($MM) | Currency | Coupon | Maturity | Issue Date | Call | Collateral |
|---|---|---|---|---|---|---|---|
| Fortis Inc. | 125 | USD | 3.53% | 12/21/2020 | 12/22/2010 | | Senior Unsecured |
| Fortis Inc. | 200 | USD | 6.60% | 09/01/2037 | 09/6/2007 | | Senior Unsecured |
| Fortis Inc. | 200 | CAD | 6.51% | 07/04/2039 | 06/26/2009 | Call +65 bps | Senior Unsecured |
| Fortis Inc. | 75 | USD | 5.26% | 12/21/2040 | 12/22/2010 | | Senior Unsecured |
| **Total Fortis Inc.** | **600** | | | | | | |
| **FortisBC Holdings** | **125** | CAD | 5.56% | 09/15/2014 | 09/10/2004 | Call +23 bps | Senior Unsecured |
| BC Gas Utility[1,2] | 75 | CAD | 11.80% | 09/30/2015 | 11/14/1990 | Putable, non-call | Mortgage |
| BC Gas Utility[1,2] | 200 | CAD | 10.30% | 09/30/2016 | 11/08/1991 | Call +35 bps | Mortgage |
| BC Gas Utility[1,2] | 150 | CAD | 6.95% | 09/21/2029 | 09/16/1999 | Call +28 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 6.50% | 05/01/2034 | 04/26/2004 | Call +31 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 150 | CAD | 5.90% | 02/26/2035 | 02/22/2005 | Call +29 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 120 | CAD | 5.55% | 09/25/2036 | 09/20/2006 | Call +34 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 6.00% | 10/02/2037 | 09/27/2007 | Call +37 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 250 | CAD | 5.80% | 05/13/2038 | 05/08/2008 | Call +40 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 250 | CAD | 6.05% | 02/15/2038 | 02/7/2008 | Call +46 bps | Senior Unsecured |
| Terasen Gas Inc.[2] | 100 | CAD | 6.55% | 02/24/2039 | 02/24/2009 | Call +71 bps | Senior Unsecured |
| Terasen Gas Vancouver[3] | 100 | CAD | 5.20% | 06/12/2040 | 12/2/2010 | Call +40 bps | Senior Unsecured |
| FortisBC Energy Inc. | 100 | CAD | 4.25% | 12/09/2041 | 12/06/2011 | Call +41 bps | Senior Unsecured |
| **FortisBC Energy Inc.** | **1,545** | | | | | | |
| **FortisBC Energy (Van) Inc.** | **350** | | | | | | |
| FortisAlberta | 200 | CAD | 5.33% | 10/31/2014 | 10/15/2004 | Call +18 bps | Senior Unsecured |
| FortisAlberta | 200 | CAD | 6.22% | 10/31/2034 | 10/15/2004 | Call +28 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.40% | 04/21/2036 | 04/06/2006 | Call +25 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 5.85% | 04/15/2038 | 04/08/2008 | Call +45 bps | Senior Unsecured |
| FortisAlberta | 100 | CAD | 7.06% | 02/14/2039 | 02/10/2009 | Call +80 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 5.37% | 10/30/2039 | 10/30/2009 | Call +34.5 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.54% | 10/18/2041 | 10/14/2011 | Call +39.5 bps | Senior Unsecured |
| FortisAlberta | 110 | CAD | 4.99% | 01/03/2047 | 12/08/2006 | Call +24 bps | Senior Unsecured |
| FortisAlberta | 125 | CAD | 4.80% | 10/27/2050 | 10/22/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisAlberta** | **1,185** | | | | | | |
| West Kootenay P&L | 15 | CAD | 9.65% | 10/16/2012 | 10/16/1992 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 140 | CAD | 5.48% | 11/28/2014 | 11/23/2004 | Call +24 bps | Senior Unsecured |
| West Kootenay P&L | 25 | CAD | 8.80% | 08/28/2023 | 08/27/1993 | Call +40 bps | Senior Secured |
| FortisBC Inc. | 100 | CAD | 5.60% | 11/09/2035 | 10/27/2005 | Call +30 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 6.10% | 06/02/2039 | 06/02/2009 | Call +49 bps | Senior Unsecured |
| FortisBC Inc. | 105 | CAD | 5.90% | 07/04/2047 | 06/22/2007 | Call +31 bps | Senior Unsecured |
| FortisBC Inc. | 100 | CAD | 5.00% | 11/24/2050 | 11/19/2010 | Call +33.5 bps | Senior Unsecured |
| **Total FortisBC** | **590** | | | | | | |
| Newfoundland Light & Power | 30 | CAD | 10.55% | 08/01/2014 | 07/20/1989 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 32 | CAD | 10.90% | 05/02/2016 | 04/10/1991 | Call +50 bps | First Mortgage |
| Newfoundland Light & Power | 34 | CAD | 9.00% | 10/01/2020 | 09/08/1992 | Call +30 bps | First Mortgage |
| Newfoundland Light & Power | 33 | CAD | 10.125% | 06/15/2022 | 05/19/1992 | Call +37 bps | First Mortgage |
| Newfoundland Light & Power | 34 | CAD | 8.90% | 05/07/2026 | 04/18/1996 | Call +20 bps | First Mortgage |
| Newfoundland Power | 44 | CAD | 6.80% | 11/20/2028 | 11/02/1998 | Non-call | First Mortgage |
| Newfoundland Power | 68 | CAD | 7.52% | 11/01/2032 | 10/16/2002 | Call +46 bps | First Mortgage |
| Newfoundland Power | 56 | CAD | 5.441% | 08/15/2035 | 08/10/2005 | | First Mortgage |
| Newfoundland Light & Power | 67 | CAD | 5.901% | 08/17/2037 | 08/13/2007 | Call +35 bps | First Mortgage |
| Newfoundland Power | 64 | CAD | 6.606% | 05/25/2039 | 08/10/2005 | Call +50 bps | First Mortgage |
| **Total Newfoundland Power** | **463** | | | | | | |
| **Total Bonds Outstanding** | **4,858** | | | | | | |

(1) Terasen Gas Inc. was formerly called BC Gas Utility.
(2) Terasen Gas Inc. has been renamed as FortisBC Energy Inc.
(3) Terasen Gas (Vancouver Island) Inc. has been renamed as FortisBC Energy (Vancouver Island) Inc.

Source: Bloomberg, Company reports, RBC Capital Markets Research

**Exhibit 7: Simplified Organizational Structure**




1. FortisBC Holdings Inc. formerly known as Terasen Inc.
2. FortisBC Energy (Vancouver Island) Inc. formerly known as Terasen Gas (Vancouver Island) Inc.
3. FortisBC Energy Inc. formerly known as Terasen Gas Inc.
4. FortisBC Energy (Whistler) Inc. formerly known as Terasen Gas (Whistler) Inc.

Source: Bloomberg, Company reports, RBC Capital Markets Research

**Diversified group of regulated utility operating companies provide stability:** Fortis receives regular dividends from its utility subsidiaries and cash flow from non-regulated businesses, providing a diversified source of cash flow to service Holdco debt. In turn, Fortis regularly injects equity into its operating utility subsidiaries to fund rate base growth and maintain utility capital structures. This strategy provides a high degree of transparency that is welcomed by utility regulators.

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Distribution of Ratings
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| | | | Investment Banking Serv./Past 12 Mos. | |
|---|---|---|---|---|
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