



An **ATCO** Company

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

**FOR THE SIX MONTHS ENDED  
JUNE 30, 2004**

## CU INC.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ("MD&A")

The following discussion and analysis of financial condition and results of operations of CU Inc. (the "Corporation") should be read in conjunction with the Corporation's unaudited comparative interim financial statements for the three and six months ended June 30, 2004, and the audited comparative financial statements and management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2003 ("2003 MD&A"). Information contained in the 2003 MD&A that is not discussed in this document remains substantially unchanged. Additional information relating to the Corporation, including the Corporation's Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

The common share capital of the Corporation consists of Class A non-voting shares ("Class A shares") and Class B common shares ("Class B shares").

#### FORWARD-LOOKING INFORMATION

Certain statements contained in this MD&A constitute forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "anticipate", "plan", "estimate", "expect", "may", "will", "intend", "should", and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Corporation believes that the expectations reflected in the forward-looking statements are reasonable, but no assurance can be given that these expectations will prove to be correct and such forward-looking statements should not be unduly relied upon.

In particular, this MD&A contains forward-looking statements pertaining to purchase obligations, planned capital expenditures, anticipated completion dates and construction costs of major projects, and the impact of changes in government regulation. The Corporation's actual results could differ materially from those anticipated in these forward-looking statements as a result of regulatory decisions, competitive factors in the industries in which the Corporation operates, prevailing economic conditions, and other factors, many of which are beyond the control of the Corporation.

#### BUSINESS OF THE CORPORATION

The Corporation's financial statements are consolidated from two segments: natural gas and electric and power generation (see Note 7 to the comparative financial statements). Transactions between segments are eliminated in all reporting of the Corporation's consolidated financial information.

#### Transfer of the Retail Energy Supply Businesses

On May 4, 2004, ATCO Gas and ATCO Electric closed the transfer of their retail energy supply businesses to Direct Energy Marketing Limited and one of its affiliates (collectively "DEML"), a subsidiary of Centrica plc ("Transfer of the Retail Energy Supply Businesses"). Proceeds of the transfer were \$90 million, of which \$45 million was paid at closing, with the remainder to be paid 12 months following closing. Net proceeds, after adjustments related to legal, transition and other deferred costs pertaining to the transfer of the retail energy supply businesses, resulted in a gain of \$63.3 million before income taxes of \$8.2 million. This transfer increased earnings for the three and six months ended June 30, 2004 by \$55.1 million.

The Corporation's revenues and natural gas supply and purchased power costs after May 4, 2004, will be reduced accordingly. Subsequent to May 4, 2004, ATCO Gas will continue to purchase natural gas on behalf of DEML pending the transfer of the relevant natural gas purchase contracts to DEML. This transfer of contracts is ongoing and is anticipated to be completed in 2004. There will be no impact on earnings resulting from the transfer of these businesses as natural gas and electricity have historically been sold to customers on a "no-margin" basis. ATCO

Gas and ATCO Electric continue to own and operate the natural gas and electricity distribution systems used to deliver energy.

Under the various transaction agreements, ATCO Gas and ATCO Electric have transferred to DEML certain retail functions, including the supply of natural gas and electricity to customers and billing and customer care functions (“the transferred functions”).

On May 4, 2004, DEML commenced supplying natural gas and electricity at regulated rates to residential, farm and small business customers in the ATCO Gas and ATCO Electric service areas and billing customers for their natural gas and electricity service.

If DEML fails to perform all or part of the transferred functions, ATCO Gas and ATCO Electric will be required under existing legislation to perform such functions in the interim until DEML is able to perform such functions. In certain events (including where DEML fails to supply natural gas and/or electricity and ATCO Gas and/or ATCO Electric are ordered by the AEUB to do so), the agreements will terminate and the functions will revert to ATCO Gas and/or ATCO Electric with no refund of the purchase price to DEML by ATCO Gas and/or ATCO Electric. In certain circumstances, if DEML is restrained or prohibited from carrying out the transferred functions, all functions will revert to ATCO Gas and ATCO Electric and a portion of the purchase price will be refunded to DEML, depending upon the timing of any such reversion.

Centrica plc, DEML’s parent, has provided a \$300 million guarantee supported by a \$235 million letter of credit in respect of DEML’s obligations to ATCO Gas, ATCO Electric and ATCO I-Tek Business Services Ltd., an affiliate corporation, in respect of the ongoing relationships contemplated under the transaction agreements. The Centrica guarantee and letter of credit include limits for certain categories of claims, which limits cease to apply if the agreements are terminated. If the amount available to be drawn under the letter of credit at any time falls below \$200 million, the agreements with DEML will terminate and the functions will revert to ATCO Gas and ATCO Electric with no refund of the purchase price to DEML by ATCO Gas and ATCO Electric.

Canadian Utilities Limited has provided a guarantee of ATCO Gas’, ATCO Electric’s and ATCO I-Tek Business Services Ltd.’s payment and indemnity obligations in respect of the ongoing relationships contemplated under the transaction agreements.

DEML has entered into a 10 year contract effective May 4, 2004, with ATCO I-Tek Business Services Ltd. to provide billing and call centre services to ensure continued quality customer service. DEML has the ability to terminate this contract after the fifth anniversary upon immediate payment of termination fees which decline over the remaining term of the contract. Based upon current customer counts and service levels and a 10 year contract, revenues are estimated to be between \$400-\$500 million over the term of the contract.

ATCO Gas and ATCO Electric have also agreed not to compete in the regulated and unregulated retail energy business in Alberta for a period of ten years.

In December 2003, the AEUB issued a decision approving the transfer of the retail operations of ATCO Gas and ATCO Electric to DEML. The City of Calgary filed for leave to appeal the AEUB decision, including the allocation of proceeds to ATCO Gas and ATCO Electric. On June 30, 2004, the Alberta Court of Appeal dismissed the City of Calgary’s application for leave to appeal. The Court of Appeal rendered an oral decision from the bench with written reasons to follow.

## SELECTED QUARTERLY INFORMATION

	For the Three Months Ended			
	March 31	June 30	Sept. 30	Dec. 31
	(\$ Millions) (unaudited)			
<b>2004</b>				
Revenues (1).....	960.0	480.7	.....	.....
Earnings attributable to Class A and Class B shares (1) (2) (3) .....	63.8	80.3	.....	.....
<b>2003</b>				
Revenues .....	1,099.2	588.7	430.2	728.1
Earnings attributable to Class A and Class B shares (2) (3) (4) .....	62.7	32.5	25.2	54.4
<b>2002</b>				
Revenues .....	.....	.....	339.7	721.5
Earnings attributable to Class A and Class B shares (2) (3) (4) .....	.....	.....	21.4	48.8

### Notes:

- (1) The three months ended June 30, 2004, includes the impact of the Transfer of the Retail Energy Supply Businesses.
- (2) There were no discontinued operations or extraordinary items during these periods.
- (3) Due to the seasonal nature of the Corporation's operations, and the timing of rate decisions, earnings for any quarter are not necessarily indicative of operations on an annual basis.
- (4) 2003 and 2002 earnings attributable to Class A shares and Class B shares have been restated for retroactive change in method of accounting for asset retirement obligations.
- (5) As all Class A and Class B shares of the Corporation are owned by Canadian Utilities Limited, the disclosure of earnings per share is not provided as it is not considered to be meaningful.
- (6) The above data has been prepared in accordance with Canadian generally accepted accounting principles and the reporting currency is the Canadian dollar.

## RESULTS OF OPERATIONS

The principal factors that caused variations in revenues for the three and six months ended June 30, 2004 were:

- lower sales of electricity and natural gas purchased for customers on a "no-margin" basis by ATCO Electric and ATCO Gas due to the Transfer of the Retail Energy Supply Businesses (refer to the Transfer of the Retail Energy Supply Businesses section), and lower prices of electricity and natural gas purchased for customers on a "no-margin" basis prior to May 4, 2004 (refer to the Natural Gas and Electric section);
- fluctuations in temperatures (refer to the Natural Gas and Electric section); and
- timing of rate decisions (refer to the Natural Gas and Electric section).

The principal factors that caused variations in earnings for the three and six months ended June 30, 2004 were:

- the Transfer of the Retail Energy Supply Businesses (refer to the Transfer of the Retail Energy Supply Businesses and the Natural Gas and Electric sections);
- fluctuations in temperatures (refer to the Natural Gas and Electric section);
- timing of rate decisions (refer to the Natural Gas and Electric section); and
- timing of plant outages in Alberta Power (2000) (refer to the Power Generation section).



- negative impact of the ATCO Electric Decision; and
- negative impact of the ATCO Pipelines AEUB decision regarding the 2003/2004 general rate application which decreased ATCO Pipelines' rate of return on common equity to 9.5% and the common equity ratio to 43.5%. This reduction in the common equity ratio reduced the common equity that ATCO Pipelines is allowed to earn a return on by \$10.6 million ("ATCO Pipelines Decision").

**Earnings attributable to Class A shares and Class B shares** for the three months ended June 30, 2004, including the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, increased by \$47.8 million to \$80.3 million.

**Earnings attributable to Class A shares and Class B shares** for the three months ended June 30, 2004, excluding the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, decreased by \$7.3 million to \$25.2 million, primarily due to:

- lower energy charges in Alberta Power (2000) due to the timing of plant outages;
- negative impact of the ATCO Electric Decision; and
- warmer temperatures in ATCO Gas.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas AEUB decision respecting the 2003/2004 general rate application that increased ATCO Gas' rate of return on common equity to 9.5% ("ATCO Gas Decision");
- lower Alberta income tax rates; and
- customer additions in ATCO Gas.

**Earnings attributable to Class A shares and Class B shares** for the six months ended June 30, 2004, including the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, increased by \$48.9 million to \$144.1 million.

**Earnings attributable to Class A shares and Class B shares** for the six months ended June 30, 2004, excluding the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, decreased by \$6.2 million to \$89.0 million, primarily due to:

- negative impacts of the ATCO Electric Decision and the ATCO Pipelines Decision;
- warmer temperatures in ATCO Gas; and
- lower energy charges in Alberta Power (2000) due to the timing of plant outages.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas decision;
- lower Alberta income tax rates; and
- customer additions in ATCO Gas.

**Operating expenses** (consisting of natural gas supply, purchased power, operation and maintenance, selling and administrative and franchise fee costs) for the three months ended June 30, 2004, decreased by \$98.7 million to \$349.6 million, primarily due to:

- lower costs of electricity and natural gas purchased for customers on a "no-margin" basis by ATCO Electric and ATCO Gas due to the Transfer of the Retail Energy Supply Businesses, and lower costs of electricity and natural gas purchased for customers on a "no-margin" basis prior to May 4, 2004; and
- lower natural gas volumes purchased for ATCO Pipelines' customers as a result of customers moving from sales service (commodity and transportation costs) to transportation service contracts (transportation costs).

This decrease was partially offset by:

- higher selling and administrative expenses associated with the impact of the ATCO Gas Decision.

**Operating expenses** for the six months ended June 30, 2004, decreased by \$241.3 million to \$1,108.0 million, primarily due to:

- lower costs of electricity and natural gas purchased for customers on a “no-margin” basis by ATCO Electric and ATCO Gas due to the Transfer of the Retail Energy Supply Businesses, and lower costs of electricity and natural gas purchased for customers on a “no-margin” basis prior to May 4, 2004; and
- lower natural gas volumes purchased for ATCO Pipelines’ customers as a result of customers moving from sales service (commodity and transportation costs) to transportation service contracts (transportation costs).

This decrease was partially offset by:

- higher selling and administrative expenses associated with the impact of the ATCO Gas Decision.

**Depreciation and amortization expenses** for the three months ended June 30, 2004, increased by \$3.4 million to \$51.3 million, primarily due to:

- capital additions in 2004 and 2003.

**Depreciation and amortization expenses** for the six months ended June 30, 2004, increased by \$7.1 million to \$110.7 million, primarily due to:

- capital additions in 2004 and 2003.

**Interest expense** for the three months ended June 30, 2004, increased by \$0.1 million to \$36.0 million, primarily due to:

- interest expense associated with the issue in January 2004 of \$180.0 million of 5.432% Debentures.

This increase was partially offset by:

- reduced interest expense associated the \$100.0 million of 8.73% Debentures 1994 Series redeemed June 1, 2004.

**Interest expense** for the six months ended June 30, 2004, increased by \$0.9 million to \$72.9 million, primarily due to:

- interest expense associated with the issue in January 2004 of \$180.0 million of 5.432% Debentures.

**Interest and other income** for the three months ended June 30, 2004, increased by \$0.3 million to \$1.6 million, primarily due to:

- increased interest income on higher cash balances.

This increase was partially offset by:

- lower rates of interest earned on cash balances.

**Interest and other income** for the six months ended June 30, 2004, increased by \$0.6 million to \$3.2 million, primarily due to:

- increased interest income on higher cash balances.

This increase was partially offset by:

- lower rates of interest earned on cash balances.

**Income taxes** for the three months ended June 30, 2004, including the \$8.2 million of income taxes resulting from the Transfer of the Retail Energy Supply Businesses, increased by \$3.0 million to \$24.9 million.

**Income taxes** for the three months ended June 30, 2004, excluding the \$8.2 million of income taxes resulting from the Transfer of the Retail Energy Supply Businesses, decreased by \$5.2 million to \$16.7 million, primarily due to:

- lower earnings; and
- lower income tax rates.

**Income taxes** for the six months ended June 30, 2004, including the \$8.2 million of income taxes resulting from the Transfer of the Retail Energy Supply Businesses, increased by \$1.1 million to \$64.5 million.

**Income taxes** for the six months ended June 30, 2004, excluding the \$8.2 million of income taxes resulting from the Transfer of the Retail Energy Supply Businesses, decreased by \$7.1 million to \$56.3 million, primarily due to:

- lower earnings; and
- lower income tax rates.

**Segmented revenues** for the three and six months ended June 30, 2004, were as follows:

<b>Business Group</b>	<b>For the Three Months Ended June 30</b>		<b>For the Six Months Ended June 30</b>	
	<b>2004</b>	2003	<b>2004</b>	2003
	(\$ Millions) (unaudited)			
Natural Gas and Electric .....	<b>413.3</b>	511.9	<b>1,297.4</b>	1,534.6
Power Generation .....	<b>68.7</b>	78.3	<b>145.6</b>	156.2
Corporate and Other .....	-	-	-	-
Intersegment eliminations.....	<b>(1.3)</b>	(1.5)	<b>(2.3)</b>	(2.9)
<b>Total.....</b>	<b>480.7</b>	588.7	<b>1,440.7</b>	1,687.9

**Segmented earnings** attributable to Class A shares and Class B shares for the three and six months ended June 30, 2004, were as follows:

<b>Business Group</b>	<b>For the Three Months Ended June 30</b>		<b>For the Six Months Ended June 30</b>	
	<b>2004</b>	2003	<b>2004</b>	2003
	(\$ Millions) (unaudited)			
Natural Gas and Electric (1) .....	<b>70.0</b>	18.3	<b>119.9</b>	67.8
Power Generation (2).....	<b>10.0</b>	14.2	<b>23.6</b>	27.4
Corporate and Other .....	<b>0.3</b>	-	<b>0.6</b>	-
Intersegment eliminations.....	-	-	-	-
<b>Total.....</b>	<b>80.3</b>	32.5	<b>144.1</b>	95.2

*Notes:*

- (1) *The earnings for the three and six months ended June 30, 2004, include earnings of \$55.1 million from the Transfer of the Retail Energy Supply Businesses.*
- (2) *2003 earnings have been restated for a retroactive change in the method of accounting for asset retirement obligations.*

## **Natural Gas and Electric**

**Revenues** from natural gas and electric operations for the three months ended June 30, 2004, decreased by \$98.6 million to \$413.3 million, primarily due to:

- lower sales of electricity and natural gas purchased for customers on a “no-margin” basis by ATCO Electric and ATCO Gas due to the Transfer of the Retail Energy Supply Businesses, and lower prices of electricity and natural gas purchased for customers on a “no-margin” basis prior to May 4, 2004;
- warmer temperatures in ATCO Gas for the three months ended June 30, 2004, which were 4.7% colder than normal, compared to 17.8% colder than normal for the corresponding period in 2003;
- lower natural gas volumes purchased for ATCO Pipelines’ customers as a result of customers moving from sales service (commodity and transportation revenues) to transportation service contracts (transportation revenue) and the negative impact of the ATCO Pipelines Decision; and
- negative impact of the ATCO Electric Decision.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas Decision; and
- customer additions in ATCO Gas.

**Revenues** for the six months ended June 30, 2004, decreased by \$237.2 million to \$1,297.4 million, primarily due to:

- lower sales of electricity and natural gas purchased for customers on a “no-margin” basis by ATCO Electric and ATCO Gas due to the Transfer of the Retail Energy Supply Businesses, and lower prices of electricity and natural gas purchased for customers on a “no-margin” basis prior to May 4, 2004;
- warmer temperatures in ATCO Gas for the six months ended June 30, 2004, which were 0.2% colder than normal, compared to 9.2% colder than normal for the corresponding period in 2003;
- lower natural gas volumes purchased for ATCO Pipelines’ customers as a result of customers moving from sales service (commodity and transportation revenues) to transportation service contracts (transportation revenue) and the negative impact of the ATCO Pipelines Decision; and
- negative impact of the ATCO Electric Decision.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas Decision; and
- customer additions in ATCO Gas.

**Earnings** for the three months ended June 30, 2004, including the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, increased by \$51.7 million to \$70.0 million.

**Earnings** for the three months ended June 30, 2004, excluding the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, decreased by \$3.4 million to \$14.9 million, primarily due to:

- negative impact of the ATCO Electric Decision; and
- warmer temperatures in ATCO Gas.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas Decision; and
- increased earnings related to ATCO Gas’ customer additions.

**Earnings** for the six months ended June 30, 2004, including the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, increased by \$52.1 million to \$119.9 million.

**Earnings** for the six months ended June 30, 2004, excluding the \$55.1 million after tax gain on the Transfer of the Retail Energy Supply Businesses, decreased by \$3.0 million to \$64.8 million, primarily due to:

- negative impacts of the ATCO Electric Decision and the ATCO Pipelines Decision; and
- warmer temperatures in ATCO Gas.

This decrease was partially offset by:

- moderately positive impact of the ATCO Gas Decision; and
- increased earnings related to ATCO Gas’ customer additions.

## **Power Generation**

**Revenues** from the power generation operations for the three months ended June 30, 2004, decreased by \$9.6 million to \$68.7 million, primarily due to:

- lower cost of service revenues in Alberta Power (2000) for the H.R. Milner generating plant which was sold by the Alberta Balancing Pool on January 29, 2004; and
- lower energy charges due to the timing of plant outages.

**Revenues** for the six months ended June 30, 2004, decreased by \$10.6 million to \$145.6 million, primarily due to:

- lower cost of service revenues in Alberta Power (2000) for the H.R. Milner generating plant which was sold by the Alberta Balancing Pool on January 29, 2004; and
- lower energy charges due to the timing of plant outages.

**Earnings** for the three months ended June 30, 2004, decreased by \$4.2 million to \$10.0 million, primarily due to:

- lower energy charges due to the timing of plant outages.

**Earnings** for the six months ended June 30, 2004, decreased by \$3.8 million to \$23.6 million, primarily due to:

- lower energy charges due to the timing of plant outages.

At June 30, 2004, the balance in the deferred availability incentive account was \$22.2 million, a decrease of \$29.2 million from March 31, 2004 and a decrease of \$21.1 million from December 31, 2003. This reduction in deferred availability incentive balances was caused primarily by the planned outages at the Battle River (see “Business Risks” below) and Sheerness generating plants. During the three months ended June 30, 2004, the amortization of deferred availability incentives, recorded in revenues, decreased by \$1.0 million to \$1.7 million.

During the six months ended June 30, 2004, the amortization of deferred availability incentives decreased by \$0.1 million to \$3.6 million.

## REGULATORY MATTERS

Regulated operations are conducted by ATCO Electric, the ATCO Gas and ATCO Pipelines divisions of ATCO Gas and Pipelines Ltd., CU Water, and the generating plants of Alberta Power (2000), all of which are wholly owned subsidiaries of the Corporation.

In December 2003, the AEUB issued a decision approving the implementation of the “One Bill Model” no later than April 1, 2004. The One Bill Model is designed to ensure that customers who choose to purchase their natural gas requirements from a retailer will receive only one bill for natural gas service. Previously, customers would receive a bill from the retailer for the purchase of the commodity and a separate bill from ATCO Gas for the delivery service. ATCO Gas has now completed implementation of this process.

On July 2, 2004, the AEUB issued its Generic Cost of Capital decision. This decision established a standardized approach for each utility company regulated by the AEUB for determining the rate of return on common equity based upon a rate of return of 9.60% on common equity. This rate of return will be adjusted annually by 75% of the change in the long term Canada bond yield as forecast in the November Consensus Forecast, adjusted for the average difference between the 10 year and 30 year Canada bond yields for the month of October as reported in the National Post. This adjustment mechanism is the same as the National Energy Board uses in determining its formula based rate of return. The AEUB will undertake a review of this mechanism for the year 2009 or if the rate of return resulting from the formula is less than 7.6% or greater than 11.6%. The AEUB also noted that any party, at any time, could petition for a review of the adjustment formula as a result of a change in circumstance.

The decision also established the appropriate capital structure for each utility regulated by the AEUB. The AEUB determined that any proposed changes to the approved capital structure which result from a material change in the investment risk of a utility will be addressed at utility specific rate applications.

Comparisons of the common equity ratios and returns on common equity approved by the AEUB in this decision versus the last AEUB approved ratios and related returns for each of the regulated entities of the Corporation are contained in the table below:

	Common Equity Ratios (%)		Returns on Common Equity (%)	
	Generic Cost of Capital Decision	Previous AEUB Approved	Generic Cost of Capital Decision	Previous AEUB Approved
ATCO Electric – Transmission .....	33.0 (1)	32.0 (3)	9.60 (1)	9.40 (3)
ATCO Electric – Distribution .....	37.0 (1)	35.0 (3)	9.60 (1)	9.40 (3)
ATCO Gas .....	38.0 (2)	37.0 (1)	- (2)	9.50 (1)
ATCO Pipelines .....	43.0 (1)	43.5 (3)	9.60 (1)	9.50 (3)

Notes:

- (1) Applies to 2004.
- (2) The common equity ratio and the return on common equity do not apply to ATCO Gas until 2005.
- (3) Applies to 2003.
- (4) As the Generic Cost of Capital decision was issued on July 2, 2004, the impact of this decision has not been recorded in the results of operations for the three and six months ended June 30, 2004, but will be recorded in the third quarter of 2004.

## **ATCO Electric**

In a decision dated October 2, 2003, the AEUB approved, among other things, a rate of return on common equity of 9.40% and a common equity ratio of 32% for ATCO Electric's transmission operations and 35% for its distribution operations for 2003. In a decision dated July 2, 2004, the AEUB issued its Generic Cost of Capital decision which approved, among other things, a return on common equity of 9.60% and a common equity ratio of 33% for ATCO Electric's transmission operations and 37% for its distribution operations for 2004.

Certain matters relating to transactions with affiliates will be addressed in separate proceedings during 2004. ATCO Electric, as directed by the AEUB, refiled the 2003 and 2004 revenue requirements, incorporating the findings in the decision. In a decision dated February 17, 2004, the AEUB issued its final determination of the revenue requirements for the 2003 and 2004 test years, accepting the refiling with no material changes.

In March 2004, ATCO Electric filed an application to settle several deferral account balances and to revise the 2004 interim distribution tariff to incorporate the AEUB decision regarding the revenue requirements for the 2003 and 2004 test years. In the application, ATCO Electric requested that an interim net refund rider be implemented for the period May 1, 2004, to December 31, 2004, to refund a total of approximately \$43 million to customers. On April 22, 2004, the AEUB approved this application as filed. This refund has no impact on earnings. ATCO Electric submitted a Phase II application to finalize the interim distribution tariff on May 21, 2004. The hearing is expected to commence in November 2004.

In September 2003, ATCO Electric received approval from the AEUB to build a \$95.0 million, 350 kilometre 240 kilovolt transmission line between Fort McMurray and Whitefish Lake. The project includes three substations and the expansion of an existing substation, all of which are expected to be substantially completed by August 31, 2004. As at June 30, 2004, ATCO Electric had completed approximately 95% of the project in record time, and had expended \$94.0 million of the total project costs. Costs were recently revised to \$99 million due to scope additions and schedule acceleration.

## **ATCO Gas**

In December 2002, the AEUB issued a decision approving rates for ATCO Gas on an interim basis effective January 1, 2003. In a decision dated October 1, 2003, the AEUB approved, among other things, a rate of return on common equity of 9.50% for 2003 and 2004 and a common equity ratio of 37%. Certain matters relating to transactions with affiliates will be addressed in separate proceedings during 2004. ATCO Gas, as directed by the AEUB, refiled the 2003 and 2004 general rate application, incorporating the findings in the decision. In a decision dated June 15, 2004, the AEUB issued its final determination of the revenue requirements for the 2003 and 2004 test years, accepting the refiling with no material changes.

In October 2001, the AEUB approved the sale by ATCO Gas of certain properties located in the City of Calgary, known as the Calgary Stores Block, for \$6.6 million (excluding costs of disposition) and subsequently issued a decision allocating \$4.1 million of the proceeds to customers, and \$1.8 million to ATCO Gas. Leave to appeal this decision was granted on July 12, 2002. On January 27, 2004, the Alberta Court of Appeal issued a decision which overturned the AEUB decision and directed the AEUB to allocate \$5.4 million of the proceeds to ATCO Gas. Subsequent to the receipt of this decision, the AEUB and the City of Calgary filed for leave to appeal the Alberta Court of Appeal decision to the Supreme Court of Canada. Accordingly, ATCO Gas has not yet recorded the impact of the appeal decision.

In March 2004, the AEUB issued a decision respecting the operation of ATCO Gas' Carbon storage facility for the 2004/2005 storage year. The decision, among other things, directed ATCO Gas to reserve 16.7 petajoules of storage

capacity for utility customers and allowed ATCO Midstream to continue to utilize the remaining uncontracted capacity at a rate of \$0.45 per gigajoule, up from \$0.41 per gigajoule. ATCO Gas has filed for leave to appeal this decision to the Alberta Court of Appeal. A hearing to address the leave to appeal is scheduled for September 14, 2004. In July 2004, the AEUB initiated a written process, commencing August 16, 2004, to consider its role in regulating the operations of the Carbon storage facility.

ATCO Gas has filed an application with the AEUB to address, among other things, corrections required to historical transportation imbalances that have impacted ATCO Gas' deferred gas account. The application requests a recovery of approximately \$11.3 million from ATCO Gas' south customers, and a refund of approximately \$2.0 million to ATCO Gas' north customers. A decision from the AEUB is expected in 2004.

## **ATCO Pipelines**

In a decision dated December 2, 2003, the AEUB approved for ATCO Pipelines, among other things, a rate of return on common equity of 9.50% and a common equity ratio of 43.5% for 2003. In a decision dated July 2, 2004, the AEUB issued its Generic Cost of Capital decision which approved, among other things, ATCO Pipelines' 2004 rate of return on common equity of 9.60% and common equity ratio of 43%.

Certain matters relating to transactions with affiliates will be addressed in separate proceedings during 2004. ATCO Pipelines, as directed by the AEUB, refiled the 2003 and 2004 general rate application, incorporating the findings in the decision. In a decision dated March 9, 2004, the AEUB approved interim rates to be effective from March 1, 2004, to October 31, 2004. In a decision dated April 30, 2004, the AEUB accepted the refiling of the revenue requirements for the 2003 and 2004 test years with no material changes. In a decision dated July 13, 2004, the AEUB awarded additional revenue with respect to the revenue forecasts of certain industrial customers.

In October 2003, ATCO Pipelines filed a 2004 Phase II general rate application for new rates. This application is part of a broader process through which the AEUB will address competitive issues between ATCO Pipelines and NOVA Gas Transmission Ltd. A hearing was held in May 2004 and a decision is expected in September 2004.

## **LIQUIDITY AND CAPITAL RESOURCES**

Cash flow from operations provides a substantial portion of the Corporation's cash requirements. Additional cash requirements are met externally through bank borrowings and the issuance of long term debt and preferred shares. Commercial paper borrowings and short term bank loans are used to provide flexibility in the timing and amounts of long term financing.

**Cash flow from operations** for the three months ended June 30, 2004, decreased by \$32.7 million to \$48.8 million, primarily due to:

- payments made by Alberta Power (2000) with respect to deferred availability incentives due to planned and unplanned plant outages; and
- lower earnings.

**Cash flow from operations** for the six months ended June 30, 2004, decreased by \$21.3 million to \$183.2 million, primarily due to:

- payments made by Alberta Power (2000) with respect to deferred availability incentives due to planned and unplanned plant outages; and
- lower earnings.

**Investing** for the three months ended June 30, 2004, increased by \$19.1 million to \$71.6 million, primarily due to:

- higher capital expenditures; and
- reduced recoveries of non-current deferred electricity costs.

This increase was partially offset by:

- proceeds from the Transfer of the Retail Energy Supply Businesses; and
- changes in non-cash working capital in respect of investing activities.



*purchases and operational contracts pertaining to the Carbon storage facility which will not be transferred to DEML and continues to be subject to AEUB regulation. Some of these obligations are for the life of the gas reserves. The estimated value of these purchase obligations is based on the market price of natural gas in effect on June 30, 2004, and assumes a remaining life of 10 years for the gas reserves. The cost of natural gas purchased under these obligations is recoverable from ATCO Gas' customers.*

- (2) *Alberta Power (2000) has fixed price long term contracts to purchase coal for its coal-fired generating plants. These costs are recoverable pursuant to the power purchase arrangements.*
- (3) *Alberta Power (2000) has entered into contracts with suppliers to improve operating efficiency at certain of its generating plants.*

At June 30, 2004, the Corporation had the following **credit lines** that enable it to obtain funding for general corporate purposes.

	<b>Total</b>	<b>Used</b>	<b>Available</b>
		(\$ Millions)	
		(unaudited)	
Short term committed .....	300.0	-	300.0
Uncommitted .....	114.1	0.1	114.0
<b>Total.....</b>	<b>414.1</b>	<b>0.1</b>	<b>414.0</b>

The amount and timing of future financings will depend on market conditions and the specific needs of the Corporation.

**Current and long term future income taxes** of \$80.4 million at June 30, 2004, are attributable to differences between the financial statement carrying amounts of assets and liabilities and their tax bases. These differences result primarily from recognizing revenue and expenses in different years for financial and tax reporting purposes. Future income taxes will become payable when such differences are reversed through the settlement of liabilities and realization of assets.

## **BUSINESS RISKS**

### **Transfer of Retail Energy Supply Businesses**

Although ATCO Gas and ATCO Electric have transferred to DEML certain retail functions, including the supply of natural gas and electricity to customers and billing and customer care functions, ATCO Gas and ATCO Electric remain legally obligated to perform these functions if DEML fails to perform. If DEML fails to perform all or part of the transferred functions, ATCO Gas and ATCO Electric will be required under existing legislation to perform such functions in the interim until DEML is able to perform such functions. In certain events (including where DEML fails to supply natural gas and/or electricity and ATCO Gas and/or ATCO Electric are ordered by the AEUB to do so), the functions will revert to ATCO Gas and/or ATCO Electric with no refund of the purchase price to DEML by ATCO Gas and/or ATCO Electric. In certain circumstances, if DEML is restrained or prohibited from carrying out the transferred functions, all functions will revert to ATCO Gas and ATCO Electric and a portion of the purchase price will be refunded to DEML, depending upon the timing of any such reversion. In the event of a reversion of such functions, ATCO Gas and ATCO Electric could incur costs related to commodity procurement, transportation and delivery charges and various regulatory costs.

Centrica plc, DEML's parent, has provided a \$300 million guarantee supported by a \$235 million letter of credit in respect of DEML's obligations to ATCO Gas, ATCO Electric and ATCO I-Tek Business Services Ltd. in respect of the ongoing relationships contemplated under the transaction agreements. However, there can be no assurance that the coverage under these agreements will be adequate to cover all of the costs that could arise in the event of a reversion of such functions.

Canadian Utilities Limited has provided a guarantee of ATCO Gas', ATCO Electric's and ATCO I-Tek Business Services Ltd.'s payment and indemnity obligations in respect of the ongoing relationships contemplated under the transaction agreements.

As a result of the agreements with DEML, ATCO Gas and ATCO Electric are no longer involved in arranging for the supply and sale of natural gas and electricity to customers, but will continue to own the assets and provide transportation and distribution services under AEUB approved rates that provide for a recovery of costs of service and fair return.

In December 2003, the AEUB issued a decision approving the transfer of the retail operations of ATCO Gas and ATCO Electric to DEML. The City of Calgary filed for leave to appeal the AEUB decision, including the allocation of proceeds to ATCO Gas and ATCO Electric. On June 30, 2004, the Alberta Court of Appeal dismissed the City of Calgary's application for leave to appeal. The Court of Appeal rendered an oral decision from the bench with written reasons to follow.

### **Late Payment Penalties on Utility Bills**

As a result of recent decisions of the Supreme Court of Canada in *Garland vs. Consumers' Gas Co.*, the imposition of late payment penalties on utility bills has been called into question. The Corporation is unable to determine at this time the impact, if any, that these decisions will have on the Corporation.

### **Alberta Power (2000)**

As a result of unprecedented drought conditions, the water level in the cooling pond used by the Battle River Plant in its production of electricity had fallen to an all-time low in early 2003, and the Corporation made a force majeure claim in respect of short term curtailed plant production which was experienced during the first quarter of 2003. The arbitration hearings with respect to the force majeure claim were concluded in June 2004, and a decision is expected during 2004. Water levels so far in 2004 are below those of 2003 which has required the Corporation to limit generation to avoid exceeding the environmental license temperature limitations. The Corporation has made a force majeure claim for the period June 24, 2004, to July 4, 2004, and the period commencing July 14, 2004. The force majeure claim will remain in force as long as water temperatures exceed environmental license requirements thereby limiting the plant's generating capacity. The outcome of any force majeure claims are not known at this time.

## **CHANGES IN ACCOUNTING POLICIES**

Effective January 1, 2004, the Corporation retroactively adopted the Canadian Institute of Chartered Accountants ("CICA") recommendations on accounting for asset retirement obligations as described below. The prior year's financial statements have been restated for the change in the method of accounting for asset retirement obligations.

The CICA recommendations on accounting for asset retirement obligations require the Corporation to identify legal obligations associated with the retirement of tangible long lived assets. To the extent that they can be quantified, these obligations are measured and recognized at fair value, which is determined using present value techniques. An asset retirement obligation is recorded as a liability, with a corresponding increase to property, plant and equipment. The liability is accreted over the estimated time period until settlement of the obligation, with the accretion expense included in depreciation and amortization. The asset is depreciated over its estimated useful life. Prior to January 1, 2004, site restoration and removal costs that are now accounted for as asset retirement obligations were accrued over the estimated remaining useful lives of the assets.

Asset retirement obligations for regulated natural gas and electric transmission and distribution assets were not recognized as the Corporation expects to use the assets in service for an indefinite period. As such, no final removal date can be determined and, consequently, a reasonable estimate of the related retirement obligations cannot be made at this time. Asset retirement obligations have been recorded for the regulated generating plants of Alberta Power (2000).

The effect of adopting these recommendations is presented as increases (decreases) below:

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
	(\$ Millions) (unaudited)			
<i>Statement of earnings</i>				
Depreciation and amortization.....	(0.3)	(0.5)	(0.6)	(1.1)
Accretion expense, included in depreciation and amortization .....	0.4	0.3	0.8	0.7
Earnings attributable to Class A and Class B shares .....	(0.1)	0.2	(0.2)	0.4

	January 1 2003
	(\$ Millions) (unaudited)
<i>Balance sheet</i>	
Retirement assets and site restoration and removal costs, included in property, plant and equipment .....	20.4
Asset retirement obligations, included in deferred credits.....	24.5
Retained earnings at beginning of period .....	(4.1)

Changes in asset retirement obligations are summarized below:

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
	(\$ Millions) (unaudited)			
Obligations at beginning of period .....	26.3	24.9	25.9	24.5
Accretion expense.....	0.4	0.3	0.8	0.7
Obligations at end of period .....	26.7	25.2	26.7	25.2

The Corporation estimates the undiscounted amount of cash flow required to settle the asset retirement obligations is approximately \$63 million, which will be incurred between 2005 and 2026. A weighted average discount rate of 5.9% was used to calculate the fair value of the asset retirement obligations.

Effective January 1, 2004, the Corporation prospectively adopted the CICA recommendations on accounting for asset impairment. These recommendations require an impairment of property, plant and equipment, intangible assets with finite lives, deferred operating costs and long term prepaid expenses to be recognized in earnings when the asset's carrying value exceeds the total cash flows expected from its use and eventual disposition. The impairment loss is then calculated as the difference between the asset's carrying value and its fair value, which is determined using present value techniques. This change in accounting had no effect on earnings for the three and six months ended June 30, 2004.

Effective January 1, 2004, the Corporation prospectively adopted the CICA recommendations that define the primary sources of GAAP. While the recommendations encourage the application of the primary sources of GAAP to all operations, the recommendations do not require that assets and liabilities arising from rate regulation be recognized and measured in accordance with the primary sources of GAAP. The Corporation has chosen to retain its existing accounting policies for its regulated operations, which are permitted by GAAP.

July 26, 2004