



An **ATCO** Company

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

**FOR THE THREE MONTHS ENDED  
MARCH 31, 2007**

## 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 interim consolidated financial statements for the three months ended March 31, 2007, and the audited consolidated financial statements and management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2006 ("2006 MD&A"). Information contained in the 2006 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 equity securities of the Corporation consist of Class A non-voting shares ("Class A shares") and Class B common shares ("Class B shares").

#### TABLE OF CONTENTS

	<u>Page</u>
Forward-Looking Information .....	2
Non-GAAP Financial Measures .....	3
Internal Control Over Financial Reporting .....	3
Business of the Corporation.....	3
Selected Quarterly Information .....	3
Results of Operations.....	4
Consolidated Operations.....	4
Segmented Information.....	5
Utilities.....	5
Power Generation.....	5
Regulatory Matters .....	6
ATCO Electric .....	6
ATCO Gas .....	7
ATCO Pipelines .....	8
Liquidity and Capital Resources.....	9
Outstanding Share Data .....	10
Business Risks .....	10
Critical Accounting Estimates .....	11
Changes in Accounting Policies .....	12

#### 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 contractual obligations, planned capital expenditures 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.

## NON-GAAP FINANCIAL MEASURES

In this MD&A, reference is made to funds generated by operations, which is a measure that does not have a standardized meaning under Canadian Generally Accepted Accounting Principles (“GAAP”). Funds generated by operations is calculated on the Corporation’s consolidated statement of cash flows from operating activities before changes in non-cash working capital. In the Corporation’s opinion, funds generated by operations is a significant performance indicator of the Corporation’s ability to generate cash flow to fund its capital expenditures

## INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes in the Corporation’s internal control over financial reporting that occurred during the three months ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

## BUSINESS OF THE CORPORATION

The Corporation’s financial statements are consolidated from two segments: Utilities and Power Generation (refer to Note 8 to the unaudited interim consolidated financial statements for the three months ended March 31, 2007). Transactions between segments are eliminated in all reporting of the Corporation’s consolidated financial information.

## SELECTED QUARTERLY INFORMATION

(\$ Millions)	For the Three Months Ended			
	Mar. 31	Jun. 30	Sep. 30	Dec. 31
		<i>(unaudited)</i>		
<b>2007</b> (1) (2)				
Revenues.....	415.7	.....	.....	.....
Earnings attributable to Class A and Class B shares.....	60.2	.....	.....	.....
<b>2006</b> (1) (2)				
Revenues.....	400.8	316.6	292.7	391.7
Earnings attributable to Class A and Class B shares.....	53.0	21.4	24.9	47.8
<b>2005</b> (1) (2)				
Revenues.....	.....	307.7	294.4	382.2
Earnings attributable to Class A and Class B shares.....	.....	27.3	24.9	45.6

### Notes:

- (1) *There were no discontinued operations or extraordinary items during these periods.*
- (2) *Due to the seasonal nature of the Corporation’s operations and the timing of rate decisions, revenues and earnings for any quarter are not necessarily indicative of operations on an annual basis.*
- (3) *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.*
- (4) *The above data has been extracted from the financial statements which have 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 have caused variations in **revenues** and **earnings** over the eight most recently completed quarters necessary to understand general trends that have developed and the seasonality of the businesses disclosed in the 2006 MD&A remain substantially unchanged.

### Consolidated Operations

**Revenues** for the three months ended March 31, 2007, **increased** by \$14.9 million to \$415.7 million, primarily due to:

- impact of 2007 interim customer rate increases for ATCO Electric approved by the Alberta Energy and Utilities Board (“AEUB”) in December 2006 (refer to Regulatory Matters – ATCO Electric section);
- customer growth in ATCO Gas; and
- colder temperatures in ATCO Gas.

This increase was partially offset by:

- lower franchise fees collected by ATCO Gas on behalf of cities and municipalities.

**Earnings attributable to Class A and Class B shares** for the three months ended March 31, 2007, **increased** by \$7.2 million to \$60.2 million, primarily due to:

- customer growth in ATCO Gas;
- reduced earnings recorded in the first quarter of 2006 as a result of the ATCO Electric GTA Decision (refer to Regulatory Matters – ATCO Electric section); and
- colder temperatures in ATCO Gas.

This increase was partially offset by:

- higher operating and maintenance and depreciation expenses 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 March 31, 2007, **increased** by \$3.2 million to \$209.7 million, primarily due to:

- higher operating and maintenance expenses in ATCO Electric and ATCO Gas.

**Depreciation and amortization expenses** for the three months ended March 31, 2007, **increased** by \$4.9 million to \$73.7 million, primarily due to:

- capital additions in 2007 and 2006.

**Interest expense** for the three months ended March 31, 2007, **increased** by \$2.2 million to \$40.7 million, primarily due to:

- interest on new financings issued in 2006 to fund capital expenditures in Utilities operations.

**Interest and other income** for the three months ended March 31, 2007, **increased** by \$1.2 million to \$3.4 million, primarily due to:

- higher short term interest rates.

**Income taxes** for the three months ended March 31, 2007, **decreased** by \$1.4 million to \$31.3 million, primarily due to:

- lower income tax rates.

## Segmented Information

**Segmented revenues and earnings attributable to Class A and Class B shares** for the three months ended March 31, 2007, were as follows:

(\$ Millions)	For the Three Months Ended March 31			
	Revenues		Earnings	
	2007	2006	2007	2006
	<i>(unaudited)</i>			
Utilities .....	<b>343.9</b>	328.3	<b>48.4</b>	40.3
Power Generation .....	<b>71.8</b>	72.5	<b>11.8</b>	12.6
Corporate and Other .....	-	-	-	0.1
Total.....	<b>415.7</b>	400.8	<b>60.2</b>	53.0

### Utilities

**Revenues** from the Utilities segment for the three months ended March 31, 2007, **increased** by \$15.6 million to \$343.9 million, primarily due to:

- impact of 2007 interim customer rate increases for ATCO Electric approved by the AEUB in December 2006, (refer to Regulatory Matters – ATCO Electric section);
- customer growth in ATCO Gas; and
- colder temperatures in ATCO Gas.

This increase was partially offset by:

- lower franchise fees collected by ATCO Gas on behalf of cities and municipalities.

Temperatures in ATCO Gas for the three months ended March 31, 2007, were 5.1% warmer than normal, compared to 6.8% warmer than normal for the corresponding period in 2006.

**Earnings** for the three months ended March 31, 2007, **increased** by \$8.1 million to \$48.4 million, primarily due to:

- customer growth in ATCO Gas;
- reduced earnings recorded in the first quarter of 2006 as a result of the ATCO Electric GTA Decision (refer to Regulatory Matters – ATCO Electric section); and
- colder temperatures in ATCO Gas.

This increase was partially offset by:

- higher operating and maintenance and depreciation expenses in ATCO Gas.

Utilities segment capital expenditures to maintain capacity and meet planned growth are expected to be approximately \$600 million in 2007. The total three year (2007-2009) anticipated capital expenditures in the Utilities segment are expected to be approximately \$2.1 billion.

### Power Generation

**Revenues** for the three months ended March 31, 2007, were **substantially unchanged**.

**Earnings** for the three months ended March 31, 2007, were **substantially unchanged**.

Alberta Power (2000) operated the Rainbow generating plant during 2006 and the electricity generated was sold to the Alberta Power Pool. Alberta Power (2000) had one year after the expiry of the Power Purchase Arrangement (“PPA”) for the Rainbow generating plant (December 31, 2005) to determine whether to decommission the plant in order to fully recover plant decommissioning costs or to continue to operate the plant. In the first quarter of 2007 the Alberta Electric System Operator (“AESO”) and Alberta Power (2000) executed a contract which will result in Alberta Power (2000) continuing to operate the plant and thus be responsible for future decommissioning costs. These costs are included in Alberta Power (2000)’s asset retirement obligation liability. As such, Alberta Power (2000) has withdrawn its application with the AEUB to decommission the plant.

During the three months ended March 31, 2007, Alberta Power (2000)’s **deferred availability incentive** account **increased** by \$6.6 million to \$46.2 million. The increase was due to additional availability incentives received for improved plant availability net of quarterly amortization. During the three months ended March 31, 2007, the amortization of deferred availability incentives, recorded in revenues, increased by \$0.3 million to \$2.9 million, compared to the same period in 2006.

## REGULATORY MATTERS

Regulated operations are conducted by wholly owned subsidiaries of the Corporation:

- ATCO Electric and its subsidiaries Northland Utilities (NWT), Northland Utilities (Yellowknife) and Yukon Electrical;
- the ATCO Gas and ATCO Pipelines divisions of ATCO Gas and Pipelines Ltd.; and
- the Battle River and Sheerness generating plants of Alberta Power (2000).

Regulated operations in Alberta (except for the generating plants of Alberta Power (2000)) are subject to a generic cost of capital regime:

- in July 2004, the AEUB issued the generic cost of capital decision which established, among other things:
  - a standardized approach for each utility company regulated by the AEUB for determining the rate of return on common equity;
    - rate of return adjusted annually by 75% of the change in long term Government of Canada bond yield as forecast; and
    - adjustment mechanism similar to the method the National Energy Board uses in determining its formula based rate of return;
  - the capital structure for each utility regulated by the AEUB.
- in November 2005, the AEUB announced a generic return on common equity of 8.93% for 2006;
- in January 2006, the AEUB clarified that the generic return on equity determined on an annual basis in accordance with the generic cost of capital decision should apply to each year of the test period in the companies’ applications. If no rate applications are filed for a particular year, then there will be no adjustment to the common equity rate of return for that year; and
- in November 2006, the AEUB announced a generic return on common equity of 8.51% for 2007.

ATCO Electric, ATCO Gas and ATCO Pipelines purchase information technology services, and ATCO Electric and ATCO Gas also purchase customer care and billing services, from ATCO I-Tek. The recovery of these costs in customer rates is subject to AEUB approval. Since 2003, the costs have been approved on a placeholder basis, and are subject to final AEUB approval after completion of an ongoing collaborative benchmarking process.

### ATCO Electric

In March 2006, the AEUB issued a decision on ATCO Electric’s 2005 and 2006 General Tariff Application (“ATCO Electric GTA Decision”):

- which established, among other things, the amount of revenue to be collected in 2005 and 2006 from customers for transmission and distribution services and approved a return on common equity as determined by the AEUB’s standardized rate of return methodology – 9.5% in 2005 and 8.93% in 2006;
- ATCO Electric’s 2005 earnings negatively impacted by \$1.3 million, recorded in first quarter of 2006; and
- ATCO Electric’s 2006 earnings reduced by an additional \$1.6 million, compared to 2005 earnings, recorded throughout 2006.

In August 2006, the AEUB approved the first phase of the AESO's application for the need to improve transmission infrastructure in northwest Alberta:

- AEUB decision grants the AESO approval to assign approximately \$300 million in projects to the Transmission Facility Owner, ATCO Electric;
- once assigned by the AESO, ATCO Electric will prepare and file facility applications with the AEUB. Construction will commence once approval to proceed is received from the AEUB; and
- the entire 725 kilometre project was originally intended to be completed by 2009, but now is anticipated to be completed by 2011. As a result of price escalation caused by the change in completion date, coupled with the increasing costs of construction in Alberta, the entire project is now estimated to cost \$400 million. ATCO Electric anticipates that an additional 180 kilometres of transmission line projects will be required in its service area over the next five years.

In November 2006, ATCO Electric filed a general tariff application with the AEUB for the 2007 and 2008 test years:

- requesting, among other things, increased revenues to recover increased financing, depreciation and operating costs associated with increased rate base in Alberta;
- a decision from the AEUB on the general tariff application is not expected until late 2007;
- in November 2006, ATCO Electric filed an application requesting interim refundable rates for transmission and distribution operations, pending the AEUB's decision on the general tariff application; and
- on December 19, 2006, ATCO Electric received a decision from the AEUB approving interim refundable rate increases amounting to 50% of ATCO Electric's requested increases for transmission and distribution operations.

## **ATCO Gas**

In January 2006, the AEUB issued a decision on ATCO Gas' 2005, 2006 and 2007 General Rate Application ("ATCO Gas GRA Decision"):

- which, among other things, established the amount of revenue to be collected over the period 2005 to 2007 from customers for natural gas distribution service and approved a return on common equity as determined by the AEUB's standardized rate of return methodology – 9.5% in 2005, 8.93% in 2006 and 8.51% in 2007.

In May 2006, the City of Calgary filed a Review and Variance application with the AEUB for the ATCO Gas GRA Decision:

- the application alleges that the AEUB made errors in the ATCO Gas GRA Decision related to the calculation of working capital needed by ATCO Gas to operate its Carbon natural gas storage facility;
- the AEUB issued its decision on January 17, 2007, denying the City of Calgary's application; and
- on February 15, 2007, the City of Calgary filed for leave to appeal this decision with the Alberta Court of Appeal.

In October 2006, ATCO Gas also filed a Review and Variance application with the AEUB for the ATCO Gas GRA Decision:

- the application alleges that the AEUB made errors in the ATCO Gas GRA Decision related to the approved level of administrative expenses;
- in December 2006, the AEUB issued a decision in which it acknowledged an error for a portion of the administrative expenses in question; and
- on April 18, 2007, ATCO Gas was advised by the AEUB that it would grant ATCO Gas' request to hear its Review and Variance application. A schedule for the hearing has not yet been determined.

ATCO Gas owns a 43.5 petajoule natural gas storage facility located at Carbon, Alberta. ATCO Gas has leased the entire storage capacity of the facility to ATCO Midstream. ATCO Gas has taken the position that the facility is no longer required for utility service and should be removed from regulation. In the process of obtaining AEUB approval, the following events are significant:

- in July 2004, the AEUB initiated a written process to consider its role in regulating the operations of the facility;
- in June 2005, the AEUB issued a decision with respect to this process. In addition to addressing other matters, the decision found that the AEUB has the authority, when necessary in the public interest, to direct a utility to utilize a particular asset in a specific manner, even over the objection of the utility;
- ATCO Gas filed for leave to appeal the decision with the Alberta Court of Appeal;
- in October 2005, the AEUB established processes to review the use of the facility for utility purposes;
- a hearing to review the use of the facility for revenue generation was held in April 2006 and a hearing to review the use of the facility for load balancing was held in June 2006. On October 11, 2006, the AEUB issued a decision confirming ATCO Gas' position that the facility is no longer required for utility service with respect to the use of the facility for load balancing purposes. The City of Calgary has filed a leave to appeal and a Review and Variance application of this decision; and
- on February 5, 2007, the AEUB issued a decision in which it determined that a legitimate utility use for the facility is that it be used for purposes of generating revenues to offset customer rates. This decision requires ATCO Gas to maintain the status quo with respect to the use of the Carbon facility including the lease of the entire storage facility to ATCO Midstream. On February 26, 2007, ATCO Gas filed for leave to appeal this decision with the Alberta Court of Appeal (refer to Business Risks – Regulated Operations – Carbon Natural Gas Storage Facility section).

ATCO Gas has filed an application with the AEUB to address, among other things, corrections required to historical transportation imbalances (the process whereby third party natural gas supplies are reconciled to amounts actually shipped in the Corporation's pipelines) that have impacted ATCO Gas' deferred gas account:

- in April 2005, the AEUB issued a decision resulting in a 15% decrease in the transportation imbalance adjustments sought by ATCO Gas. The decision resulted in a decrease to ATCO Gas' 2005 revenues and earnings of \$1.8 million and \$1.2 million, respectively; and
- the City of Calgary filed for leave to appeal the AEUB's decision. ATCO Gas filed a cross appeal of the AEUB's decision. The leave to appeal was heard by the Alberta Court of Appeal on April 18, 2006. On July 7, 2006, the Alberta Court of Appeal issued its decision granting the City of Calgary's leave to appeal on the question of whether the AEUB erred in law or jurisdiction in assuming that it had the authority to allow recovery in 2005, for costs relating to prior years. ATCO Gas' cross appeal was denied. At a hearing with the Alberta Court of Appeal on April 13, 2007, the Court declined to consider Calgary's appeal and referred the jurisdictional question back to the AEUB.

### **ATCO Pipelines**

In March 2007, the AEUB directed ATCO Pipelines to file its next General Rate Application by October 1, 2007. ATCO Pipelines anticipates that the filing will include the 2008 and 2009 test years:

- requesting, among other things, increased revenues to recover increased financing, depreciation and operating costs associated with increased rate base in Alberta; and
- a decision from the AEUB on the General Rate Application is not expected until the third quarter of 2008.

The AEUB has delayed its review of the competitive natural gas pipeline issues under AEUB jurisdiction until mid 2007. This review is expected to address competitive issues between ATCO Pipelines and NOVA Gas Transmission Ltd.

### **Other Matters**

The Corporation has a number of other regulatory filings and regulatory hearing submissions before the AEUB for which decisions have not been received. The outcome of these matters cannot be determined at this time.

## LIQUIDITY AND CAPITAL RESOURCES

Funds generated by operations provide 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.

**Funds generated by operations** for the three months ended March 31, 2007, **increased** by \$2.7 million to \$141.4 million, primarily due to:

- increased earnings.

This increase was partially offset by:

- decreased availability incentives in Alberta Power (2000).

**Investing** for the three months ended March 31, 2007, **increased** by \$22.2 million to \$120.3 million, primarily due to:

- higher capital expenditures.

This increase was partially offset by:

- changes in non-cash working capital; and
- lower contributions by utility customers for extensions to plant.

**Purchase of property, plant and equipment** for the three months ended March 31, 2007, **increased** by \$12.1 million to \$120.4 million, primarily due to:

- increased investment in regulated electric distribution and transmission projects and regulated natural gas distribution projects.

During the three months ended March 31, 2007, the Corporation **issued**:

- no long term debt.

During the three months ended March 31, 2007, the Corporation **redeemed**:

- no long term debt.

On April 18, 2007, CU Inc. issued \$115.0 million Cumulative Redeemable Preferred Shares Series 1 at a price of \$25.00 per share for cash. The dividend rate has been fixed at 4.60%. The net proceeds of the issue will be used in part to redeem all of the outstanding Cumulative Redeemable Second Preferred Shares Series Q, R and S ("Series Q, R and S Preferred Shares") of ATCO Electric, ATCO Gas and ATCO Pipelines (\$91.8 million). In addition, on May 18, 2007, Alberta Power (2000) will redeem all of its outstanding Series Q, R and S Preferred Shares (\$34.7 million). All of the Series Q, R and S Preferred Shares are held by Canadian Utilities Limited, CU Inc.'s parent corporation.

At March 31, 2007, 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)			
Short term committed .....	300.0	10.0	290.0
Uncommitted .....	29.1	0.4	28.7
<b>Total</b> .....	<b>329.1</b>	<b>10.4</b>	<b>318.7</b>

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

Contractual obligations disclosed in the 2006 MD&A remain substantially unchanged as at March 31, 2007.

**Net current and long term future income tax liabilities** of \$54.5 million at March 31, 2007, 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.

## **OUTSTANDING SHARE DATA**

At April 24, 2007, the Corporation had outstanding 124 Class A shares and 76 Class B shares, all of which are owned by Canadian Utilities Limited.

## **BUSINESS RISKS**

ATCO Electric, ATCO Gas and ATCO Pipelines are regulated primarily by the AEUB, which administers acts and regulations covering such matters as rates, financing, accounting, construction, operation and service area. The AEUB may approve interim rates or approve the recovery of costs, including capital and operating costs, on a placeholder basis, subject to final determination. These subsidiaries are subject to the normal risks faced by companies that are regulated. These risks include the approval by the AEUB of customer rates that permit a reasonable opportunity to recover on a timely basis the estimated costs of providing service, including a fair return on rate base. The Corporation's ability to recover the actual costs of providing service and to earn the approved rates of return depends on achieving the forecasts established in the rate-setting process.

### **Environmental Matters**

The Government of Canada is proposing to regulate greenhouse gas ("GHG") emissions under a new act, the Clean Air Act. The Corporation is unable to determine what impact the Clean Air Act may have on its operations, as the government has not provided industry with details.

In March 2007, the Government of Alberta introduced legislation (Bill 3, Climate Change and Emissions Management Amendment Act and the Specified Gas Emitters Regulation Amendment) that will require Alberta facilities that emit 100,000 tonnes or more of GHG to reduce facility emission intensities by 12% starting July 1, 2007. Units commissioned before January 1, 2000, or that have less than nine years of commercial operation are required to reduce their emission intensity by 2% per year starting in the fourth year of commercial operation to a maximum of 12% in the ninth year of commercial operation. While it is not certain, it is anticipated that the Corporation's coal-fired plant PPAs will allow the Corporation to recover most of the costs associated with the implementation of Bill 3. The estimated cost to Alberta Power (2000) is approximately \$0.9 million per year.

Alberta Environment implemented a mercury emission regulation in March 2006 for Alberta Power (2000)'s coal-fired generating plants. The regulation requires coal-fired plant operators to monitor mercury emissions and capture at least 70% of the mercury in the coal starting January 1, 2011. While it is not certain, it is anticipated that the PPAs will allow the Corporation to recover most of the costs associated with complying with the new regulation.

### **Carbon Natural Gas Storage Facility**

ATCO Gas leases the entire storage capacity of the Carbon natural gas storage facility to ATCO Midstream at AEUB approved placeholder rates. On February 5, 2007, the AEUB issued a decision to ATCO Gas that leaves in question these placeholder rates and the effect that these placeholder rates will have on future ATCO Gas revenues (refer to Regulatory Matters – ATCO Gas section).

### **Weather**

Weather fluctuations have a significant impact on throughput in ATCO Gas. Since approximately 50% of ATCO Gas' delivery charge is recovered based on throughput, ATCO Gas' revenues and earnings are sensitive to weather. Weather that is 10% warmer or colder than normal temperatures impacts annual earnings by approximately \$10.0 million.

## **ATCO I-Tek Services**

ATCO Electric, ATCO Gas and ATCO Pipelines purchase information technology services, and ATCO Electric and ATCO Gas also purchase customer care and billing services, from ATCO I-Tek. The recovery of these costs in customer rates is subject to AEUB approval. Since 2003, the costs have been approved on a placeholder basis, and are subject to final AEUB approval after completion of an ongoing collaborative benchmarking process.

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

On May 4, 2004, ATCO Gas and ATCO Electric transferred their retail energy supply businesses to Direct Energy Marketing Limited and one of its affiliates (collectively “DEML”), a subsidiary of Centrica plc.

Although ATCO Gas and ATCO Electric transferred to DEML certain retail functions, including the supply of natural gas and electricity to customers and billing and customer care functions, the legal obligations of ATCO Gas and ATCO Electric remain if DEML fails to perform. 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 transfer proceeds to DEML by ATCO Gas and/or ATCO Electric.

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 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’ payment and indemnity obligations to DEML contemplated under the transaction agreements.

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

As a result of 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.

## **Measurement Inaccuracies in Metering Facilities**

Measurement inaccuracies occur from time to time with respect to ATCO Electric’s, ATCO Gas’ and ATCO Pipelines’ metering facilities. Measurement adjustments are settled between the parties based on the requirements of the Electricity and Gas Inspections Act (Canada) and applicable regulations issued pursuant thereto. There is a risk of disallowance of the recovery of a measurement adjustment if controls and timely follow up are found to be inadequate by the AEUB.

A recent AEUB decision applicable to ATCO Gas established a two year adjustment limitation period for inaccuracies in gas supply costs, including measurement inaccuracies in metering facilities. The AEUB stated that it will consider specific applications for adjustments beyond the two year limitation period.

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of the Corporation’s consolidated financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the year. On an on-going basis, management reviews its estimates, particularly those related to depreciation and amortization methods, useful lives and impairment of long-lived assets, amortization of deferred availability incentives, asset retirement obligations and employee future benefits, using currently available information. Changes in facts and circumstances may result in revised estimates,

and actual results could differ from those estimates. The Corporation's critical accounting estimates are discussed below.

### **Deferred Availability Incentives**

Alberta Power (2000) is subject to an incentive/penalty regime related to generating unit availability. As at March 31, 2007, the Corporation had recorded \$46.2 million of deferred availability incentives. For the three months ended March 31, 2007, the amortization of deferred availability incentives, which was recorded in revenues, amounted to \$2.9 million.

The amount to be amortized is dependent upon estimates of future generating unit availability and future electricity prices over the term of the PPA's. Each quarter, the Corporation uses these estimates to forecast high case, low case and most likely scenarios for the incentives to be received from, less penalties to be paid to, the PPA counterparties. These forecasts are added to the accumulated unamortized deferred availability incentives outstanding at the end of the quarter; the resulting total is divided by the remaining term of the PPA to arrive at the amortization for the quarter.

Compared to the most likely scenario recorded in revenues for the year to date, the high case scenario would have resulted in higher revenues of approximately \$1.1 million, whereas the low case scenario would have resulted in lower revenues of approximately \$1.1 million.

### **CHANGES IN ACCOUNTING POLICIES**

Effective January 1, 2007, the Corporation prospectively adopted the Canadian Institute of Chartered Accountants ("CICA") recommendations pertaining to financial instruments, which establish standards for the recognition, measurement, disclosure and presentation of financial assets, financial liabilities and non-financial derivatives. These recommendations require that fair value be used to measure financial assets that are held for trading or available for sale, financial liabilities that are held for trading and all derivative financial instruments. Other financial assets, such as loans and receivables and investments that are held to maturity, and other financial liabilities are measured at their carrying value. This change in accounting had the following effect on the consolidated financial statements for the three months ended March 31, 2007:

- (a) Restatement of opening retained earnings at January 1, 2007 associated with the recognition of certain financial assets and financial liabilities at amortized cost using the effective interest method (refer to Note 3 to the unaudited interim consolidated financial statements for the three months ended March 31, 2007).
- (b) Reclassification of deferred financing charges from other assets to long term debt (refer to Note 4 to the unaudited interim consolidated financial statements for the three months ended March 31, 2007).

Effective January 1, 2007, the Corporation prospectively adopted the CICA recommendations pertaining to hedges, which establish standards for the identification, designation, documentation and effectiveness of hedging relationships for the purpose of applying hedge accounting. The purpose of hedge accounting is to ensure that gains, losses, revenues and expenses from effective hedging relationships are recorded in earnings in the same period. This change in accounting had no effect on the consolidated financial statements for the three months ended March 31, 2007.

Effective January 1, 2007, the Corporation prospectively adopted the CICA recommendations regarding the reporting and disclosure of comprehensive income. Comprehensive income consists of changes in the equity of the Corporation from sources other than the Corporation's share owners, and includes earnings of the Corporation and unrealized gains and losses on changes in fair values of available-for-sale assets and effective cash flow hedging instruments. Other comprehensive income comprises revenues, expenses, gains and losses that are recognized in comprehensive income but are excluded from earnings of the period. Comprehensive income is disclosed in a separate statement in the consolidated financial statements.

Effective January 1, 2007, the Corporation prospectively adopted the CICA recommendations regarding the presentation of equity and changes in equity. These recommendations require separate presentation of the components of equity, including retained earnings, accumulated other comprehensive income, contributed surplus, share capital and reserves, and the changes therein. As a result of this change in accounting, the Corporation has

included disclosure regarding accumulated other comprehensive income in the notes to the consolidated financial statements (refer to Note 6 to the unaudited interim consolidated financial statements for the three months ended March 31, 2007).

Effective January 1, 2007, the Corporation adopted the CICA recommendations that prescribe the criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Adoption of these recommendations had no effect on the consolidated financial statements for the three months ended March 31, 2007, except for the disclosure of accounting changes that have been issued by the CICA but have not yet been adopted by the Corporation because they are not effective until a future date (refer to Future Accounting Changes below).

### **Future Accounting Changes**

The CICA has issued new accounting recommendations for capital disclosures which require disclosure of both qualitative and quantitative information that enables users of financial statements to evaluate the Corporation's objectives, policies and processes for managing capital. These recommendations are effective for the Corporation beginning January 1, 2008.

The CICA has also issued new accounting recommendations for disclosure and presentation of financial instruments which require disclosures of both qualitative and quantitative information that enables users of financial statements to evaluate the nature and extent of risks arising from financial instruments to which the Corporation is exposed. These recommendations are effective for the Corporation beginning January 1, 2008.

April 25, 2007