

# FORTISALBERTA INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three and six months ended June 30, 2013

July 23, 2013

The following Management's Discussion and Analysis ("MD&A") of FortisAlberta Inc. (the "Corporation") should be read in conjunction with the following: (i) the unaudited interim financial statements and notes thereto for the three and six months ended June 30, 2013 prepared in accordance with accounting principles generally accepted in the United States ("GAAP"); (ii) the audited financial statements and notes thereto for the year ended December 31, 2012 prepared in accordance with GAAP; and (iii) the MD&A for the year ended December 31, 2012.

### FORWARD-LOOKING STATEMENTS

*The Corporation includes forward-looking information in the MD&A within the meaning of applicable securities laws in Canada ("forward-looking information"). The purpose of the forward-looking information is to provide management's expectations regarding the Corporation's future growth, results of operations, performance, business prospects and opportunities and may not be appropriate for other purposes. All forward-looking information is given pursuant to the "safe harbour" provisions of applicable Canadian securities legislation. The words "anticipates", "believes", "budgets", "could", "estimates", "expects", "forecasts", "intends", "may", "might", "plans", "projects", "schedule", "should", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. The forward-looking information reflects management's current beliefs and is based on information currently available to management.*

*The forward-looking information in the MD&A includes, but is not limited to, statements regarding: the expected timing of filing of regulatory applications and receipt of regulatory decisions; the expectation that sufficient cash will be generated to pay all operating costs and interest expense from internally generated funds; the expectation that sufficient cash to finance ongoing capital expenditures will be generated from a combination of long-term debt and short-term borrowings, internally generated funds and equity contributions; the expectation that the Corporation will continue to have access to the required capital on reasonable market terms; and the Corporation's forecast gross capital expenditures for 2013. The forecasts and projections that make up the forward-looking information are based on assumptions that include, but are not limited to: the receipt of applicable regulatory approvals and requested rate orders; no significant operational disruptions or environmental liability due to a catastrophic event or environmental upset caused by severe weather, other acts of nature or other major events; the continued ability to maintain the electricity systems to ensure their continued performance; favourable economic conditions; no significant variability in interest rates; sufficient liquidity and capital resources; maintenance of adequate insurance coverage; the ability to obtain licences and permits; retention of existing service areas; continued maintenance of information technology infrastructure; favourable labour relations; and sufficient human resources to deliver service and execute the capital program.*

*The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors that could cause results or events to differ from current expectations include, but are not limited to: regulatory risk; loss of service areas; environmental risks; capital resources and liquidity risks; operating and maintenance risks; weather and general economic conditions in geographic areas where the Corporation operates; risk of failure of information technology infrastructure; insurance coverage risk; risk of loss of permits; labour relations risk; human resources risk; adverse results from litigation; and the impact of accounting policies issued by Canadian or provincial standard setters.*

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

## THE CORPORATION

The Corporation is a regulated electricity distribution utility in the Province of Alberta. Its business is the ownership and operation of electricity distribution facilities that distribute electricity generated by other market participants from high-voltage transmission substations to end-use customers. The Corporation does not own or operate generation or transmission assets and is not involved in the direct sale of electricity. It is intended that the Corporation remain a regulated electricity utility for the foreseeable future, focusing on the delivery of safe, reliable and cost-effective electricity services to its customers in Alberta.

The Corporation operates a largely rural, approximately 117,000 kilometre, low-voltage distribution network in central and southern Alberta, which serves approximately 513,000 electricity customers comprised of residential, commercial, farm, oil and gas, and industrial consumers.

The Corporation is regulated by the Alberta Utilities Commission (the "AUC") pursuant to the *Alberta Utilities Commission Act* (the "AUC Act"). The AUC's jurisdiction, pursuant to the *Electric Utilities Act* (the "EUA"), the *Public Utilities Act*, the *Hydro and Electric Energy Act* and the *AUC Act*, includes the approval of distribution tariffs for regulated distribution utilities such as the Corporation, including the rates and terms and conditions on which service is to be provided by those utilities. The timing of recognition of certain assets, liabilities, revenues and expenses as a result of regulation may differ from that otherwise expected using GAAP for entities not subject to rate regulation.

Effective January 1, 2013, the AUC prescribed that distribution utilities in Alberta, including the Corporation, move to a form of rate regulation referred to as performance-based regulation ("PBR") for a five-year term. Under PBR, a formula that estimates inflation annually and assumes productivity improvements is used to determine distribution rates on an annual basis. Each year this formula is applied to the preceding year's distribution rates and for 2013 the formula was applied to the 2012 distribution rates. The 2012 distribution rates were set using a traditional cost-of-service model whereby the AUC established the Corporation's revenue requirements, being those revenues corresponding to the costs associated with the distribution business, and provided a rate of return on a deemed equity component of capital structure ("ROE") applied to rate base assets. The Corporation's ROE for ratemaking purposes was 8.75% for 2012 with a deemed equity capitalization of 41%. For 2013, an ROE of 8.75% was established by the AUC on an interim basis.

The PBR plan includes mechanisms for the recovery or settlement of items determined to flow through directly to customers ("Y factor") and the recovery of costs related to capital expenditures that are not being recovered through the inflationary factor of the formula ("K factor" or "capital tracker"). The AUC also approved a Z factor, a PBR re-opener and an ROE efficiency carry-over mechanism. The Z factor permits an application for recovery of costs related to significant unforeseen events. The PBR re-opener permits an application to re-open and review the PBR plan to address specific problems with the design or operation of the PBR plan. The use of the Z factor and PBR re-opener mechanisms is associated with certain thresholds. The ROE efficiency carry-over mechanism provides an efficiency incentive by permitting a utility to continue to benefit from any efficiency gains achieved during the PBR term for two years following the end of that term.

The Corporation is an indirect, wholly-owned subsidiary of Fortis Inc. ("Fortis"), which is a diversified, international electricity and gas distribution utility holding company having investments in distribution, transmission and generation utilities, real estate and hotel operations.

## REGULATORY MATTERS

### Performance-Based Regulation and 2013 Distribution Rates

In September 2012, the AUC issued Decision 2012-237 (the "PBR Decision") which approved the transition to PBR for a five-year term beginning in 2013 for Alberta distribution utilities. The formula determined by the AUC in the PBR Decision raises concerns and uncertainty for the Corporation regarding the treatment of certain capital expenditures. While the PBR Decision did provide a capital tracker mechanism for the recovery of costs related to certain capital expenditures, the Corporation sought further clarification regarding this mechanism in a Review and Variance application and a Capital Tracker application and sought leave to appeal the issue with the Alberta Court of Appeal.

In March 2013, the AUC issued Decision 2013-071 which denied the Review and Variance application. The Corporation has filed leave to appeal the denial of the Review and Variance application on similar grounds as the leave to appeal of the PBR Decision. Both appeals have been adjourned pending further determinations in the outstanding PBR-related proceedings.

In March 2013, the AUC also issued Decision 2013-072 (the "Interim Compliance Decision") regarding the Compliance applications filed by all the distribution utilities. The Interim Compliance Decision approved a combined inflation and productivity factor of 1.71%, certain adjustments to the Corporation's going-in rates including specific flow-through amounts, Y factor, and a placeholder equal to 60% of the applied for capital tracker, K factor, amount. The AUC stated that the K factor placeholder provides a reasonable balance between the utilities' 2013 forecast rate adjustments related to capital trackers and potential customer rate shock implications.

The Interim Compliance Decision resulted in an interim increase to distribution rates of approximately 4% effective January 1, 2013 with collection from customers effective April 1, 2013. A final decision on the Compliance application was received in July directing the Corporation to continue to use the interim rates until all remaining 2013 placeholders have been determined. A hearing on the Capital Tracker application which will address, among other things, the K factor placeholder commenced in June 2013. A decision on the Capital Tracker application is expected in the second half of 2013 and could result in further adjustments to the 2013 distribution rates.

### Utility Asset Disposition Proceeding

In the 2011 Generic Cost of Capital Decision (the "2011 GCOC Decision"), the AUC made statements regarding cost responsibility for stranded assets, which the Corporation and other utilities challenge as being incorrectly made. As a result, the Corporation together with other Alberta utilities filed a Review and Variance application with the AUC. In June 2012, the AUC decided it would not permit a review and variance of the decision in question, but would examine the issue in a Utility Asset Disposition ("UAD") proceeding reinitiated in November 2012. The Corporation and the other utilities had sought leave to appeal the AUC's pronouncement on the treatment of stranded assets in the 2011 GCOC Decision with the Alberta Court of Appeal, and have temporarily adjourned that court process pending the AUC's follow-up proceeding. Any decision by the AUC regarding the treatment of stranded assets does not alter a utility's right, under the *EUA*, to a reasonable opportunity to recover the prudent costs of service and the right to earn a reasonable return on equity.

On July 31, 2013, the Corporation and the other utilities will file responses to a second round of information requests in the UAD proceeding, after which the AUC will commence deliberations with a decision expected in the fourth quarter of 2013.

### 2013 Generic Cost of Capital

In October 2012, the AUC initiated a 2013 Generic Cost of Capital proceeding (the "2013 GCOC proceeding") to establish a final ROE for 2013 and revisit the matter of a formula-based approach to setting annual ROE. In November 2012, the 2013 GCOC proceeding was suspended until other regulatory matters were resolved.

In April 2013, the AUC recommended the 2013 GCOC proceeding to set the ROE and capital structure for Alberta utilities for 2013 as well as the ROE for 2014. In addition, an interim ROE for 2015 will be established. In this proceeding the AUC may consider the possibility of re-establishing a formula-based approach to setting annual ROE. The process for the 2013 GCOC proceeding commenced in the second quarter of 2013 and a hearing is scheduled for early 2014. The outcome of this proceeding is currently unknown.

### Phase II Distribution Tariff Application

In January 2013, the Corporation filed a Phase II Distribution Tariff application (the "Phase II DTA") which proposed rates by customer class based on a cost allocation study. The Phase II DTA requested that the 2012 interim distribution rates by customer class be made final for 2012 and 2013, subject to further adjustments as a result of the PBR Decision and determinations in outstanding PBR-related proceedings. The Phase II DTA also requested that Phase II adjustments between customer classes be applied to rates effective January 1, 2014. The Phase II DTA will continue as a written proceeding with a decision expected from the AUC in the third quarter of 2013. The outcome of this proceeding is currently unknown; however, it is not expected to have a material impact on the Corporation's 2013 financial results.

## RESULTS OF OPERATIONS

### Highlights

(\$ thousands)	Three Months Ended June 30			Six Months Ended June 30		
	2013	2012	Variance	2013	2012	Variance
Revenues	116,570	110,129	6,441	234,833	218,376	16,457
Cost of sales	38,411	37,461	950	78,690	76,140	2,550
Depreciation	31,460	26,087	5,373	63,320	57,494	5,826
Amortization	4,376	4,392	(16)	8,572	7,891	681
Other income	-	-	-	1,729	1,763	(34)
Income before interest and income taxes	42,323	42,189	134	85,980	78,614	7,366
Interest expense	18,151	16,663	1,488	34,651	31,794	2,857
Income before income taxes	24,172	25,526	(1,354)	51,329	46,820	4,509
Income tax expense (recovery)	95	(21)	116	484	(234)	718
Net income	24,077	25,547	(1,470)	50,845	47,054	3,791

Net income for the three months ended June 30, 2013 decreased \$1.5 million compared to the same period last year. The decrease was mainly due to lower revenue associated with net transmission volume variances and the timing of the recognition of a regulatory decision impacting depreciation expense during 2012, partially offset by the timing of operating expense and rate base growth associated with continued investment in energy infrastructure and growth in the number of customers.

Net income for the six months ended June 30, 2013 increased \$3.8 million compared to the same period last year. The increase was mainly due to timing of operating expense and rate base growth associated with continued investment in energy infrastructure and growth in the number of customers, partially offset by lower revenue associated with net transmission volume variances.

In June 2013 parts of the Corporation's service territory were impacted by the flooding in southern Alberta. The financial results for the three and six months ended June 30, 2013 were not materially impacted by restoration efforts related to the flood. Restoration efforts continue and the final impact on the Corporation's operations, assets, earnings and cash flows is not fully determined at this time.

The following table outlines the significant variances in the Results of Operations for the three months ended June 30, 2013 as compared to June 30, 2012:

Item	Variance (\$ millions)	Explanation
Revenues	6.4	<p>Electric rate revenue increased by \$9.4 million primarily due to the interim distribution rate increase of approximately 4% effective January 1, 2013 and growth in the number of customers. Further, there were net increases in revenues related to flow-through items which were fully offset in cost of sales.</p> <p>Other revenue decreased by \$3.0 million due to positive net transmission volume variances recognized in the second quarter of 2012. As approved by the AUC, net transmission volume variances were recognized in revenue during 2012 but deferred on the balance sheet as a regulatory asset or liability effective January 1, 2013.</p>
Cost of sales	1.0	<p>The increase was primarily due to higher labour and benefit costs driven by inflation, net increases in costs that qualify as flow-through items which were fully offset in revenue, and timing of certain operating expenses. The increases were partially offset by lower vehicle expenses mainly due to lower fuel costs.</p> <p>Labour and benefit costs and contracted manpower costs comprised approximately 63.1% of total cost of sales.</p>
Depreciation and amortization	5.4	The increase was due to continued investment in capital assets and the recognition in the second quarter of 2012 of the cumulative impact of an overall decrease in depreciation rates effective January 1, 2012.
Interest expense	1.5	The increase was primarily attributable to the issuance of long-term debt in October 2012.

The following table outlines the significant variances in the Results of Operations for the six months ended June 30, 2013 as compared to June 30, 2012:

Item	Variance (\$ millions)	Explanation
Revenues	16.5	<p>Electric rate revenue increased by \$17.4 million primarily due to the interim distribution rate increase of approximately 4% effective January 1, 2013 and growth in the number of customers. Further, there were net increases in revenues related to flow-through items which were fully offset in cost of sales.</p> <p>Other revenue decreased by \$0.9 million primarily due net transmission volume variances, partially offsetting the higher miscellaneous revenue.</p>
Cost of sales	2.6	<p>The increase was primarily due to higher labour and benefit costs driven by inflation, contracted manpower costs mainly related to the timing of vegetation management, net increases in costs that qualify as flow-through items which were fully offset in revenue, and timing of certain operating expenses. The increases were partially offset by lower vehicle expenses mainly due to lower fuel costs.</p> <p>Labour and benefit costs and contracted manpower costs comprised approximately 62.6% of total cost of sales.</p>
Depreciation and amortization	6.5	The increase was due to continued investment in capital assets.
Interest expense	2.9	The increase was primarily attributable to the issuance of long-term debt in October 2012.

## SUMMARY OF QUARTERLY RESULTS

The following table sets forth certain unaudited quarterly information of the Corporation:

(\$ thousands)	Revenues	Net Income
June 30, 2013	116,570	24,077
March 31, 2013	118,263	26,768
December 31, 2012	114,398	23,097
September 30, 2012	116,252	26,016
June 30, 2012	110,129	25,547
March 31, 2012	108,247	21,507
December 31, 2011	102,149	16,571
September 30, 2011	102,660	17,931

Changes in revenues and net income from quarter to quarter are a result of many factors including regulatory decisions, energy deliveries, number of customer sites, ongoing investment in energy infrastructure, and changes in income tax expense due to fluctuations in future income tax expenses and recoveries resulting from changes in deferral account balances, availability of tax recoveries and levels of taxable income. The allowance for funds used during construction ("AFUDC") is recognized in the first and fourth quarters of the year. As approved by the AUC, net transmission volume variances were recognized in revenue during 2012 but deferred on the balance sheet as a regulatory asset or liability effective January 1, 2013. There is no significant seasonality in the Corporation's operations.

### **June 30, 2013/March 31, 2013**

Net income for the quarter ended June 30, 2013 decreased \$2.7 million compared to the quarter ended March 31, 2013. Revenue decreased by \$1.7 million mainly due to the true-up to actual of the 2012 net transmission volume variances recognized in the first quarter. Cost of sales decreased \$1.9 million primarily due to timing of expenses. Other income decreased \$1.7 million and interest expense increased \$1.6 million related to the equity and debt portions of the AFUDC, respectively, which were recorded in the first quarter.

### **March 31, 2013/December 31, 2012**

Net income for the quarter ended March 31, 2013 increased \$3.7 million compared to the quarter ended December 31, 2012. Revenue increased by \$3.9 million primarily due to the interim distribution rate increase of approximately 4%, higher franchise fee revenue and an increase in customers. Cost of sales decreased \$1.6 million primarily due to the timing of general operating costs and use of contracted manpower, partially offset by inflationary increases in labour and benefit costs and higher franchise fees. Depreciation increased \$1.3 million primarily due to an increase in capital assets.

### **December 31, 2012/September 30, 2012**

Net income for the quarter ended December 31, 2012 decreased by \$2.9 million compared to the quarter ended September 30, 2012. Revenue decreased by \$1.9 million primarily due to a decrease in net transmission volume variances of \$1.3 million and a decrease in A1 rider revenue, partially offset by an increase in demand and customers. Cost of sales increased by \$1.9 million primarily due to higher labour and benefit costs and timing of general operating costs. Depreciation increased by \$1.3 million primarily due to an increase in capital assets. The decreases in net income were partially offset by an increase in other income of \$1.7 million and a decrease of \$1.6 million in interest expense related to the equity and debt portions of the AFUDC, respectively. The decrease in interest expense was partially offset by interest on the long-term debt issued in October 2012.

**September 30, 2012/June 30, 2012**

Net income for the quarter ended September 30, 2012 increased by \$0.5 million compared to the quarter ended June 30, 2012. Revenue increased by \$6.1 million primarily due to an increase in demand and customers. Cost of sales increased by \$2.6 million mainly due to an increase in other taxes, general operating expenses and materials. Depreciation increased by \$3.1 million mainly due to the \$3.0 million reduction for the first quarter impact of an AUC approved reduction in depreciation rates being recorded in the second quarter of 2012.

**June 30, 2012/March 31, 2012**

Net income for the quarter ended June 30, 2012 increased by \$4.0 million compared to the quarter ended March 31, 2012. Revenue increased by \$1.9 million primarily due to an increase in net transmission volume variances of \$3.0 million as a result of the discontinuance of the full deferral of transmission costs, partially offset by reductions in A1 rider revenue and franchise fee revenue which resulted in corresponding reductions in cost of sales. Depreciation decreased by \$5.3 million due to the reduction in overall depreciation rates including the \$3.0 million reduction for the first quarter as the impact of the AUC approved reduction in depreciation rates was recorded in the second quarter of 2012, partially offset by higher depreciation expense related to increased capital assets. The increases in net income were partially offset due to a decrease in other income of \$1.8 million and an increase in interest expense by \$1.5 million related to the equity and debt portions of the AFUDC, respectively, which was recorded in the first quarter.

**March 31, 2012/December 31, 2011**

Net income for the quarter ended March 31, 2012 increased \$4.9 million compared to the quarter ended December 31, 2011. Revenues increased by \$6.1 million primarily due to an average 5.0% increase in distribution rates effective January 1, 2012 and an increase in customers. Depreciation increased by \$0.7 million due to an increase in capital assets.

**December 31, 2011/September 30, 2011**

Net income for the quarter ended December 31, 2011 decreased by \$1.4 million compared to the quarter ended September 30, 2011. Revenues decreased by \$0.5 million due primarily to lower demand and recording the impact of the 2011 GCOC Decision in the fourth quarter partially offset by an increase in customers. Cost of sales increased by \$2.8 million primarily due to an increase in labour and general operating costs. The decreases in net income were partially offset by an increase in other income of \$1.7 million and a decrease of \$1.7 million in interest expense as a result of recording AFUDC in the fourth quarter, partially offset by an increase in interest on the long-term debt issued in October 2011.

## FINANCIAL POSITION

The following table outlines the significant changes in the Balance Sheet as at June 30, 2013 as compared to December 31, 2012:

Item	Variance (\$ millions)	Explanation
<b>Assets:</b>		
Income tax receivable (current and long-term)	6.4	The increase was mainly due to the expected refund of 2013 installments which are estimated based on the preceding year's tax expense.
Regulatory assets (current and long-term)	26.6	The increase was primarily due to increases in the deferred income tax regulatory deferral and deferred overhead costs. In addition, the Interim Compliance Decision resulted in the recognition of new regulatory assets related to the interim increase in distribution rates as discussed in the "Regulatory Matters" section.
Property, plant and equipment	139.4	The increase was due to continued investment in energy infrastructure, partially offset by depreciation and customer contributions.
<b>Liabilities:</b>		
Accounts payable and other current liabilities	(64.7)	The decrease was primarily due to the timing of payment to the Alberta Electric System Operator ("AESO") for 2012 transmission costs of \$44.8 million and a net decrease of \$23.0 million related to the refund of customer deposits as the associated transmission connected projects were completed during the period. These decreases were partially offset by an increase in general trade payables.
Regulatory liabilities (current and long-term)	23.0	The increase was primarily due to an increase in the 2013 AESO charges deferral, which is expected to be refunded to customers in 2013, and an increase in the provision for future site restoration costs.
Deferred income tax (deferred income tax liabilities net of current deferred income tax assets)	18.2	The increase was primarily due to higher temporary differences relating to capital assets.
Long-term debt	94.0	The increase was due to higher drawings under the committed credit facility in support of the Corporation's capital expenditure program.

## SOURCES AND USES OF LIQUIDITY AND CAPITAL RESOURCES

The Corporation's primary sources of liquidity and capital resources are the following:

- funds generated from operations;
- the issuance and sale of debt instruments;
- bank financing and operating lines of credit; and
- equity contributions from the Corporation's parent.

## STATEMENT OF CASH FLOWS

(\$ thousands)	Three Months Ended June 30			Six Months Ended June 30		
	2013	2012	Variance	2013	2012	Variance
Cash, beginning of period	917	5,485	(4,568)	44,072	-	44,072
Cash from (used in)						
Operating activities	57,848	75,824	(17,976)	68,577	197,137	(128,560)
Investing activities	(118,844)	(110,442)	(8,402)	(208,209)	(180,465)	(27,744)
Financing activities	88,455	29,133	59,322	123,936	(16,672)	140,608
Cash, end of period	28,376	-	28,376	28,376	-	28,376

### Operating Activities

For the three months ended June 30, 2013, net cash provided from operating activities was \$18.0 million lower than for the same period in 2012. The decrease was primarily due to timing of collection of accounts receivable balances and higher cash expenses paid related to an increase in cost of sales. Also contributing to the decrease was lower cash flow associated with customer deposits related to transmission connected projects and higher income tax installments.

For the six months ended June 30, 2013, net cash provided from operating activities was \$128.6 million lower than for the same period in 2012. The decrease was primarily attributable to cash flow associated with customer deposits related to transmission connected projects. During the six months ended June 30, 2013, \$23.0 million of deposits were refunded to customers compared to the receipt of \$45.2 million of deposits from customers during the six months ended June 30, 2012. Also contributing to the reduction in cash provided from operations was the timing of payments to the AESO for transmission costs, higher income tax installments, timing of collection of accounts receivable balances and higher cash expenses paid related to an increase in cost of sales.

The Corporation expects to be able to pay all operating costs and interest expense out of operating cash flows, with some residual available for dividend payments to the parent company and/or capital expenditures.

## Investing Activities

(\$ thousands)	Three Months Ended June 30			Six Months Ended June 30		
	2013	2012	Variance	2013	2012	Variance
Capital expenditures:						
Customer growth <sup>(1)</sup>	43,667	46,973	(3,306)	92,744	89,565	3,179
Externally driven and other <sup>(2)</sup>	15,702	10,863	4,839	25,217	19,255	5,962
Sustainment <sup>(3)</sup>	23,782	29,643	(5,861)	36,338	54,381	(18,043)
AESO contributions <sup>(4)</sup>	47,830	37,391	10,439	66,292	36,566	29,726
Gross capital expenditures	130,981	124,870	6,111	220,591	199,767	20,824
Less: customer contributions	(11,738)	(9,499)	(2,239)	(24,775)	(18,503)	(6,272)
Net capital expenditures	119,243	115,371	3,872	195,816	181,264	14,552
Adjustment to net capital expenditures for:						
Non-cash working capital	(865)	(8,174)	7,309	10,431	(5,181)	15,612
Costs of removal, net of salvage proceeds	2,271	4,894	(2,623)	6,491	9,077	(2,586)
Capitalized depreciation, AFUDC and other	(1,805)	(1,649)	(156)	(4,529)	(4,695)	166
Cash used in investing activities	118,844	110,442	8,402	208,209	180,465	27,744

**Notes:**

<sup>(1)</sup> Includes new customer connections

<sup>(2)</sup> Includes upgrades associated with substations, line moves, new connections for independent power producers and the distribution control centre

<sup>(3)</sup> Includes planned maintenance, capacity increases, facilities, vehicles and information technology

<sup>(4)</sup> Reflects the Corporation's required contributions towards transmission projects as determined by the AUC approved investment levels and paid when transmission projects are approved

For the three months ended June 30, 2013, the Corporation invested \$131.0 million in property, plant and equipment and intangible assets, compared to \$124.9 million for the same period in 2012. Capital expenditures related to customer growth decreased \$3.3 million primarily due to delayed projects as weather conditions were less favourable during the second quarter of 2013. Externally driven and other capital increased \$4.8 million primarily due to higher expenditures for upgrades associated with substations and the continued construction of the distribution control centre, partially offset by fewer line moves during the quarter. Sustainment capital was \$5.9 million lower due to the timing of capital expenditures related to capacity and system improvements and planned system maintenance. AESO contributions were \$10.4 million higher as a result of the approval of a number of large transmission projects during 2013 compared to 2012.

For the six months ended June 30, 2013, the Corporation invested \$220.6 million in property, plant and equipment and intangible assets, compared to \$199.8 million for the same period in 2012. Capital expenditures related to customer growth increased \$3.2 million primarily due to a large commercial project in northern Alberta, partially offset by delayed projects as weather conditions were less favourable during the second quarter of 2013. Externally driven and other capital increased \$6.0 million primarily due to higher expenditures for upgrades associated with substations and the continued construction of the distribution control centre, partially offset by fewer line moves. Sustainment capital was \$18.0 million lower due to the timing of capital expenditures related to capacity and system improvements and planned system maintenance. AESO contributions were \$29.7 million higher as a result of the approval of a number of large transmission projects during 2013 compared to 2012.

It is expected that ongoing capital expenditures will be financed from funds generated by operating activities, drawings on the committed credit facility, proceeds from issuance of debt, and equity contributions from Fortis via Fortis Alberta Holdings Inc., the Corporation's parent and an indirectly wholly owned subsidiary of Fortis.

### Capital Expenditures Forecast

The Corporation has forecast gross capital expenditures for 2013 of approximately \$444.9 million, up \$13.3 million from the \$431.6 million disclosed in the MD&A for the year ended December 31, 2012. The increase was due to higher customer capital mainly in the oil and gas sector and higher AESO contributions.

The 2013 capital expenditures are based on detailed forecasts, which include numerous assumptions such as customer demand, weather, cost of labour and material and other factors that could cause actual results to differ from forecast.

### Financing Activities

For the three months ended June 30, 2013, cash from financing activities increased \$59.3 million compared to the same period in 2012. This increase was primarily due to an equity injection of \$55.0 million received from Fortis and an \$8.0 million increase in net borrowings under the committed credit facility.

For the six months ended June 30, 2013, cash from financing activities increased \$140.6 million compared to the same period in 2012. This increase was primarily due to an \$85.0 million increase in net borrowings under the committed credit facility and an equity injection of \$55.0 million received from Fortis.

The Corporation anticipates it will be able to meet interest payments on outstanding indebtedness from internally generated funds, but expects to rely upon the proceeds of new indebtedness to meet the principal obligations when due.

## COMMITMENTS

The Corporation's commitments have not changed materially from those disclosed in the MD&A for the year ended December 31, 2012, except as discussed below.

During the second quarter of 2013, the Corporation filed an actuarial valuation of the defined benefit component of the pension plan for funding purposes as at December 31, 2012. The actuarial valuation resulted in a decrease in the minimum pension contributions to approximately \$1.6 million for 2013, compared to \$2.3 million as disclosed in the MD&A for the year ended December 31, 2012. The actuarial valuation also set the minimum pension contributions for 2014 and 2015 at approximately \$1.6 million per year.

## CAPITAL MANAGEMENT

The Corporation's objective when managing capital is to ensure ongoing access to capital to allow it to build and maintain the electricity distribution facilities within the Corporation's service territory. To ensure this access to capital, the Corporation targets a capital structure that includes approximately 59% debt and 41% equity, which is consistent with the 2011 GCOC Decision. This targeted capital structure excludes the effects of goodwill and other items that do not impact the deemed regulatory capital structure. This ratio is maintained by the Corporation through the issuance of bonds or other debt and/or equity contributions by Fortis via Fortis Alberta Holdings Inc.

### Summary of Capital Structure

As at:	June 30, 2013		December 31, 2012	
	\$ millions	%	\$ millions	%
Short-term and long-term debt	1,403.2	57.0	1,309.2	57.3
Shareholder's equity	1,056.6	43.0	975.6	42.7
	2,459.8	100.0	2,284.8	100.0

The Corporation has externally imposed capital requirements by virtue of its Trust Indenture and committed credit facility that limit the amount of debt that can be incurred relative to equity. As at June 30, 2013, the Corporation was in compliance with these externally imposed capital requirements.

As at June 30, 2013, the Corporation has an unsecured committed credit facility with an available amount of \$250.0 million maturing in August 2016. Drawings under the committed credit facility are available by way of prime loans, bankers' acceptances and letters of credit. Prime loans bear an interest rate of prime and bankers' acceptances are issued at the applicable bankers' acceptance discount rate plus a stamping fee of 1.0%. The average interest rate for the six months ended June 30, 2013 on the committed credit facility was 2.3% (six months ended June 30, 2012 – 2.3%). As at June 30, 2013, there were \$94 million in drawings under the committed credit facility (December 31, 2012 – nil) and \$0.4 million drawn in letters of credit (December 31, 2012 – \$0.4 million).

In July 2013, the Corporation renegotiated and amended its syndicated credit facility, extending the maturity date of the facility to August 2018 from August 2016. The amended agreement contains substantially similar terms and conditions as the previous agreement.

## OUTSTANDING SHARES

Authorized – unlimited number of:

- Common shares;
- Class A common shares; and
- First preferred non-voting shares, redeemable, cumulative dividend at 10% of the redemption price. Subject to applicable law, the Corporation shall have the right to redeem, at any time, all or any part of the then outstanding first preferred shares for \$348.9 million together with any accrued and unpaid dividends up to the redemption date.

Issued – 63 Class A common shares, with no par value.

## RELATED PARTY TRANSACTIONS

In the normal course of business, the Corporation transacts with Fortis and other subsidiaries of Fortis. Amounts due to or from related parties were measured at the exchange amount and were as follows:

As at: (\$ thousands)	June 30, 2013	December 31, 2012
<b>Accounts receivable</b>		
Housing loan <sup>(1)</sup>	600	670
Housing equity advance	-	435
Other loans <sup>(2)</sup>	49	18
Related parties	3	19
	652	1,142
<b>Accounts payable and other current liabilities</b>		
Related parties	-	2

Notes:

<sup>(1)</sup> This loan is to an officer of the Corporation and is interest-free for a period of nine years from the loan grant date after which interest will accrue at the rate of prime plus 0.5%. The loan must be repaid within ten years of the grant date and is secured by a mortgage on the residence purchased by the officer.

<sup>(2)</sup> These loans are to employees of the Corporation and include stock option loans, employee share purchase plan loans and employee personal computer purchase program loans.

The Corporation bills related parties on terms and conditions consistent with billings to third parties. These require amounts to be paid on a net 30 day basis with interest on overdue amounts charged at a rate of 1.5% per month (19.56% per annum). Terms and conditions on amounts billed to the Corporation by related parties are net 30 days with interest being charged on any overdue amounts.

Related party transactions included in other revenue and cost of sales were measured at the exchange amount and were as follows:

(\$ thousands)	Three Months Ended June 30		Six Months Ended June 30	
	2013	2012	2013	2012
Included in other revenue <sup>(1)</sup>	22	52	60	91
Included in cost of sales <sup>(2)</sup>	1,066	791	1,942	1,590

Notes:

<sup>(1)</sup> Includes services provided to subsidiaries of Fortis related to metering, information technology, material sales and intercompany employee services.

<sup>(2)</sup> Includes charges from Fortis relating to corporate governance expenses, stock-based compensation costs, consulting services and travel and accommodation expenses.

All services provided to or received from related parties were billed on a cost-recovery basis.

## FINANCIAL INSTRUMENTS

### Designation and Valuation of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement is required to reflect the assumptions that market participants would use in pricing a financial asset or financial liability based on the best available information. These assumptions include the risks inherent in a particular valuation technique, such as a pricing model, and the risks inherent in the inputs to the model. A fair value hierarchy exists which prioritizes the inputs used to measure fair value.

The three levels of the fair value hierarchy are defined as follows:

Level 1: Fair value determined using unadjusted quoted prices in active markets;

Level 2: Fair value determined using pricing inputs that are observable; and

Level 3: Fair value determined using unobservable inputs only when relevant observable inputs are not available.

The fair values of the Corporation's financial instruments reflect a point-in-time estimate based on current and relevant market information about the instruments as at the balance sheet dates. The estimates cannot be determined with precision as they involve uncertainties and matters of judgment; therefore, may not be relevant in predicting the Corporation's future earnings or cash flows.

The following table represents the fair value measurements of the Corporation's financial instruments.

Long-term debt as at: (\$ thousands)	June 30, 2013	December 31, 2012
Fair value <sup>(1)</sup>	1,591,672	1,609,235
Carrying value	1,403,158	1,309,151

Note:

<sup>(1)</sup> The fair value of the long-term debt was estimated using level 2 inputs based on the indicative prices for the same or similarly rated issues for debt of the same remaining maturities.

The carrying value of financial instruments included in current assets, long-term accounts receivable and current liabilities on the balance sheet approximate their fair value, which reflects the short-term maturity, normal trade credit terms and/or nature of these financial instruments.

**Derivatives**

The Corporation currently does not have any stand-alone derivative instruments as defined under the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 815, *Derivatives and Hedging*.

The Corporation conducted a review of contractual agreements for embedded derivatives. Under ASC 815, a derivative must meet three specific criteria to be accounted for under this standards codification. For contracts entered into by the Corporation, all potential embedded derivatives reviewed by the Corporation were closely related with the economic characteristics and risks of the underlying contract, had no notional amount that could be used to measure the instrument, or had no value.

**Risk Management**

Exposure to counterparty credit risk, interest rate risk and liquidity risk arises in the normal course of the Corporation's business. The Corporation currently does not enter into derivative financial instruments to reduce exposure to any of the risks impacting operations. The Corporation enters into financial instruments to finance operations in the normal course of business.

**Counterparty Credit Risk**

Counterparty credit risk is the financial risk associated with the non-performance of contractual obligations by counterparties. The Corporation extends credit to select counterparties in the normal course of business.

The Corporation monitors its credit exposure in accordance with the Terms and Conditions of Distribution Access Service as approved by the AUC. The following table provides information on the counterparties that the Corporation extends credit to with respect to its distribution tariff billings as at June 30, 2013.

Credit Rating	Number of Counterparties	Gross Exposure (\$ thousands)	Net Exposure (\$ thousands)
AAA to AA (low)	1	1,251	-
A (high) to A (low)	8	37,872	-
BBB (high) to BBB (low)	8	8,010	-
Not rated	29	57,795	483
<b>Total</b>	<b>46</b>	<b>104,928</b>	<b>483</b>

Gross exposure represents the projected value of retailer billings over a 37-day period. The Corporation is required to minimize its gross exposure to retailer billings by obtaining an acceptable form of prudential, which includes a cash deposit, bond, letter of credit, an investment grade credit rating from a major rating agency, or a financial guarantee from an entity with an investment grade credit rating.

Retailers with investment grade credit ratings have the exposure shown as nil since the credit rating serves to reduce the amount of prudential. For retailers that do not have an investment grade credit rating, the exposure is calculated as the projected value of billings over a 37-day period less the prudential held by the Corporation. The Corporation assesses non-retailer billings on an individual basis for collectability and these billings are not subject to obtaining prudential.

Factors such as volatility in the global capital markets and a slowdown in the Alberta economy could cause a reduction in the credit quality of some of the Corporation's customers. In the event that the prudential obtained by the Corporation is not sufficient to cover a loss due to non-payment from the Corporation's counterparties, the Corporation would review all other options available to collect the non-payment; however, these options would not ensure that a loss could be avoided.

The accounts receivable of the Corporation are not impaired and the aging analysis of accounts receivable, excluding goods and services tax receivable, was as follows:

As at: (\$ thousands)	June 30, 2013	December 31, 2012
Not past due	110,697	110,647
Past due 0-60 days	5,385	3,911
Past due 61 days and over	846	2,735
<b>Total</b>	<b>116,928</b>	<b>117,293</b>

**Interest Rate Risk**

Interest rate risk is the financial risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Corporation's debentures bear fixed interest rates of which the Corporation recovers in current distribution rates, thereby minimizing cash flow variability due to interest rate exposures. If the Corporation issues new fixed rate debentures within the five-year PBR term it would be exposed to cash flow variability to the extent that the inflation and productivity factor of the PBR formula may not fully provide for the interest payments. The fair value of the Corporation's current fixed rate debentures fluctuates as market interest rates change; however, the Corporation plans to hold these debentures until maturity thereby mitigating the risk of these fluctuations. The drawings under the Corporation's committed credit facility are at current market short-term interest rates, exposing the Corporation to some cash flow risk, but minimal fluctuations in fair value.

The Corporation's committed credit facility has interest rate and fee components that are sensitive to the Corporation's credit ratings. The Corporation is rated by Dominion Bond Rating Service Limited ("DBRS") and Standard and Poor's ("S&P") and a change in rating by either of these rating agencies could potentially increase or decrease the interest expense of the Corporation. As at June 30, 2013, the Corporation was rated by DBRS at A (low) and by S&P at A- .

During the first quarter of 2013 the Corporation discontinued its engagement with Moody's Investors Service.

**Liquidity Risk**

Liquidity risk is the financial risk that the Corporation will encounter challenges in meeting obligations associated with financial liabilities. The Corporation anticipates it will be able to meet interest payments on outstanding indebtedness from internally generated funds but expects to rely upon the proceeds of new indebtedness to meet the principal obligations when due.

Factors such as volatility experienced in the global capital markets may increase the cost of issuing long-term debt and impact the Corporation's future funding obligations and/or pension expense associated with its defined benefit pension plan. There are a number of risks associated with the Corporation's defined benefit pension plan including: (i) that the Corporation's defined benefit pension plan will not earn the assumed rate of return; (ii) that market driven changes may result in changes in the discount rates and other variables, which would result in the Corporation being required to make contributions in the future that differ from the estimates; and (iii) that there is measurement uncertainty in the actuarial valuation process. These risks are expected to be mitigated as the Corporation makes application in rates to collect from customers the actual cash payments required to be made into the Corporation's defined benefit and defined contribution pension plans. Therefore, an increase or decrease in the Corporation's future funding obligations and/or pension expense is expected to be collected or refunded in future customer rates, subject to forecast risk. The defined benefit pension plan assets are invested in a 100% long-term bond fund, which reduces the forecast risk on future defined benefit funding obligations.

The Corporation's outstanding financial liabilities as at June 30, 2013, include accounts payable and accrued liabilities, and long-term debt. The Corporation expects to settle its financial liabilities relating to accounts payable and accrued liabilities in accordance with their contractual terms of repayment, which are generally within one year.

The following table summarizes the number of years to maturity of the principal outstanding and interest payments on the Corporation's long-term debt, including drawings on the committed credit facility, as at June 30, 2013:

(\$ thousands)	Total	Due within 1 year	Due in years 2 and 3	Due in years 4 and 5	Due after 5 years
Drawings under the committed credit facility <sup>(1)(2)</sup>	94,000	-	-	94,000	-
Senior unsecured debentures:					
Principal payments <sup>(2)</sup>	1,310,000	-	200,000	-	1,110,000
Interest payments	1,685,217	70,261	124,533	119,203	1,371,220
<b>Total</b>	<b>3,089,217</b>	<b>70,261</b>	<b>324,533</b>	<b>213,203</b>	<b>2,481,220</b>

Notes:

<sup>(1)</sup> The Corporation's committed credit facility had a maturity date of August 2016 which was subsequently extended to August 2018. The drawings under the committed credit facility were bankers' acceptances, which had their own contractual maturity dates. The amounts shown above reflect the principal and interest due when the current bankers' acceptances mature. This balance will fluctuate between June 30, 2013 and the maturity date of the committed credit facility.

<sup>(2)</sup> Payments are shown exclusive of discounts.

## SIGNIFICANT ACCOUNTING ESTIMATES

The preparation of the Corporation's financial statements in accordance with GAAP requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Estimates and judgments are based on historical experience, current conditions and various other assumptions believed to be reasonable under the circumstances.

Due to changes in facts and circumstances, and the inherent uncertainty in making estimates, actual results may differ materially from current estimates. Estimates and judgments are reviewed periodically and as adjustments become necessary they are recognized in the period they become known. There were no material changes to the Corporation's significant accounting estimates during the six months ended June 30, 2013 from those disclosed in the MD&A for the year ended December 31, 2012.

## CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2013, the Corporation prospectively adopted Accounting Standards Update 2013-02 which amended ASC 220, *Comprehensive Income*. The amendments improve the reporting of reclassifications out of accumulated other comprehensive income ("AOCI") and require entities to report, in one place, information about reclassifications out of AOCI and to disclose additional information about changes in AOCI balances by component and significant items reclassified out of AOCI. An entity must now disaggregate the total change of each component of other comprehensive income ("OCI") and separately present reclassification adjustments and current period OCI. The amendments did not have a material effect on the Corporation's interim financial statements for the three and six months ended June 30, 2013.

## BUSINESS RISK

The Corporation's business risks have not changed materially from those disclosed in the Business Risk and Outlook sections of the MD&A for the year ended December 31, 2012.

*Note: Additional information concerning FortisAlberta Inc. including the Annual Information Form is available on SEDAR at [www.sedar.com](http://www.sedar.com).*