



Methodology

*Rating North American Energy Utilities
(Electric, Natural Gas, and Pipelines)*

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Insight beyond the rating.

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TABLE OF CONTENTS

I. Overview	4
II. General Business Risk Profile	5
Key Considerations in Evaluating a Company's Business Risk Profile	5
III. General Financial Risk Profile	7
Key Considerations in Evaluating a Company's Financial Risk Profile	7
IV. Industry-Specific Factors	9
Key Considerations in Evaluating North American Energy Utilities (Electric, Natural Gas and Pipelines)	9
Primary Factors	9
Secondary Factors	12



I. Overview

DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security, or an obligation. They are opinions based on forward-looking measurements that assess a company's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, or dividend) with respect to the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations. The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness that would be more critical for a peer company. Conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.

DBRS rating methodology is underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to global economic changes DBRS generally factors the impact of a cyclical economic environment into its rating. Consequently, DBRS takes a longer-term "through the cycle" view of a company and, as such, rating changes are not based solely on normal economic cycles. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS analysis is its broad industry coverage, which it undertakes in order to understand the major differences and subtle nuances within a particular industry and to form an appropriate rating of a company relative to its competitors.

As a framework, DBRS rating methodologies consist of three components that together form the basis of the rating: an assessment of the company's general business risk profile based on cross-industry and macro business considerations; an assessment of the company's financial risk profile primarily based on quantitative ratio analysis; and consideration of industry-specific factors and measures particularly unique to the company. To some extent, the business risk and financial risk profiles are inter-related. The degree of financial risk considered acceptable for a company depends to a large measure on the business risks it faces.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee and the role of the DBRS rating committee as the final decision maker. DBRS rating committees, which are comprised of experienced and knowledgeable DBRS personnel, strive to provide objective and independent rating decisions which are based upon all relevant information and factors, incorporate both global and local considerations, apply DBRS approved methodologies and reflect the opinion of DBRS.

II. General Business Risk Profile

A fundamental component of DBRS analysis is the consideration of macro business factors that apply to most, if not all, industries within the Corporate sector. The general business risk profile is largely a qualitative assessment of the environment a company is affected by and operates in. An assessment of the general business risk profile serves as a backdrop for the analysis of the company's financial risk profile as well as other qualitative and quantitative factors that are particularly unique to the company. Differing business risk profiles impact the assessment of a company's financial risk profile, and thus, it is important to understand the extraneous influences and business factors a company is or could be affected by despite its financial strength.

KEY CONSIDERATIONS IN EVALUATING A COMPANY'S BUSINESS RISK PROFILE

The following considerations, while not intended to be an exhaustive list, indicate the key areas DBRS considers in evaluating a company's business risk profile:

Economic Environment

The importance of the industry within the overall economy, in terms of either how it impacts or is impacted by the economy, shapes a company's viability. How the industry is influenced by current economic factors such as inflation or deflation, supply and demand, interest rates, currency swings and demographics.

Legislative and Regulatory Environment

Whether an industry is regulated The degree of regulation and legislative oversight can severely restrict or assist a company depending on its stage of growth, industry influence and regulatory relations. A regulated industry imposes a certain rigor and governance. It is also important to understand the frequency of change or stability in industry rules and whether regulations may require companies to make costly modifications to their infrastructure.

Competitive Environment

The nature of the market structure (e.g. monopoly versus oligopoly) determines the extent of competitiveness and the barriers to entry a company may face. Many industries are undergoing significant structural changes such as consolidation or deconsolidation, excess capacity, or competitive threats from new capacity in "low-cost" countries such as China, Brazil, and Russia in both domestic and international markets. Even small changes in the competitive environment can have a profound impact on a company.

Country Risk

Governments often intervene in their economies and occasionally make substantial changes in policy regarding competition, ownership, wage and price controls, restrictions on foreign currency, capital and imports/exports, among other things. Such policy changes can significantly affect a company, and therefore, considerations include the company's main location or country of operation, the extent of government intervention and support, and the degree of economic and political stability. The assessment of country risk is not limited to direct government actions to interfere with the private sector, but also encompasses the full range of financial and economic events that can spill across a country, causing widespread defaults in otherwise healthy corporate credits. As such, country risk can have considerable implications for corporate ratings. A country ceiling is assigned to corporate foreign currency ratings based on the country's susceptibility to systemic shocks and the private sector's ability to maintain its foreign currency debt payments when shocks occur.



III. General Financial Risk Profile

The financial risk profile is largely a quantitative assessment of the company's financial strength and an estimation of its future performance and financial profile. DBRS reviews three key areas: earnings, cash flow, and additional measures for balance sheet and financial flexibility. Within each area, DBRS focuses on key metrics and considerations which are assessed over time noting that the trend in the ratios is also important to the rating. However, ratios alone cannot be used as an absolute test of financial strength. With a focus on future expectations, the primary goal of financial risk assessment is to understand the inter-relationship between the numbers, interpret what they mean, and determine what they indicate about the company's ability to service and repay debt on a timely basis given the industry background.

KEY CONSIDERATIONS IN EVALUATING A COMPANY'S FINANCIAL RISK PROFILE

The following financial considerations and ratios tend to be analyzed for the majority of industries in the Corporate sector. There may be additional quantitative factors and ratios that are considered on an industry-specific basis which are noted under Section IV - Industry Specific-Factors.

Also refer to the *Corporate Sector – Glossary of Ratio Definitions*.

A. Earnings

DBRS earnings analysis focuses on core or normalized earnings and in doing so considers issues such as: the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g. company is a low-cost producer); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations. DBRS generally reviews company budgets and forecasts for future periods. Segmented breakdowns by division are also typically part of DBRS's analysis.

Typical earnings ratios include:

- Gross margin
- Return on common equity
- Return on capital
- EBIT margin and EBITDA margin

B. Cash Flow/Coverage

DBRS cash flow analysis focuses on the core cash flow generating ability of the company to service current debt obligations and other cash requirements as well as the future direction of cash flow. From a credit analysis perspective, insufficient cash sources can create financial flexibility problems even though net income metrics may be favourable. DBRS evaluates the sustainability and quality of a company's core cash flow by focusing on cash flow from operations and free cash flow before and after working capital changes. Using core or normalized earnings as a base, DBRS adjusts cash flow from operations for as much non-recurring items as possible. In terms of outlook, DBRS focuses on the projected direction of free cash flow, the liquidity and coverage ratios, and the company's ability to internally versus externally fund debt reduction and future capital expenditure and dividend/stock repurchase programs, as applicable.



Typical cash flow ratios include:

- EBIT interest coverage and EBITDA interest coverage
- EBIT fixed charges coverage
- Cash flow/total debt and Cash flow/adjusted total debt
- Cash flow/capital expenditures
- Capital expenditures/depreciation
- Debt/EBITDA
- Dividend payout ratio

C. Balance Sheet and Financial Flexibility Considerations

As part of determining the overall financial risk profile, DBRS evaluates various other factors to measure the strength and quality of the company's assets and its financial flexibility.

From a balance sheet perspective, DBRS focuses on the quality and composition of assets including goodwill and other intangibles, off-balance-sheet risk, and capital strength including the quality of capital, appropriateness of leverage to asset quality, and the ability to raise new capital. DBRS also reviews the company's strategies for growth including capital expenditures, plans for maintenance or expansion, and the expected source for funding these requirements. Where the numbers are considered significant and the adjustments would meaningfully impact the credit analysis, DBRS adjusts certain ratios for items such as operating leases, derivatives, securitizations, hybrid issues, off-balance-sheet liabilities and various other accounting issues.

Typical balance-sheet ratios include:

- Current ratio
- Turnover – Receivables and inventory
- Asset coverage (times)
- Per cent total debt to capital and per cent adjusted total debt to capital
- Per cent adjusted net debt to capital

The following factors focus on the company's liquidity:

- Maintaining sufficient bank-lines or cash balances;
- Prudent use of cash balances for dividends or stock repurchases;
- Terms and conditions of credit facilities including unique terms and/or financial covenants;
- Debt management approach including dependence on short-term versus long-term debt, fixed versus variable rate debt, and debt maturity schedule;
- Interest rate and/or foreign exchange exposure;
- Relationship and strength or weakness of a parent holding company or associated companies, if applicable.

IV. Industry-Specific Factors

Each industry within the Corporate sector has unique features that cannot be broadly applied across all industries. For example, capital spending is a key area in the utilities industry, reserves are particular to the mining industry, adequate R&D is critical for the pharmaceutical industry, and seasonality significantly impacts merchandisers. Against the backdrop of the general business and financial risk profiles, a company's unique strengths, weaknesses and industry-specific issues need to be factored into the credit analysis to form an appropriate rating. These particular business and financial issues and measures also help to shape the company's status relative to its peers.

KEY CONSIDERATIONS IN EVALUATING NORTH AMERICAN ENERGY UTILITIES (ELECTRIC, NATURAL GAS AND PIPELINES)

Energy utilities are typically characterized by very low business risk and aggressive, but relatively stable financial metrics based on supportive regulatory frameworks and/or contractual arrangements. Competitive forces are typically low-to-moderate relative to other industries.

As a result of the stability that can be provided by the regulated and/or contractual frameworks, energy utilities typically have a much higher degree of financial leverage and lower interest coverage ratios than equivalently-rated industrial companies. However, higher ratings for energy utilities are typically justified by the low variability inherent in their business risk, capital structure, and earnings and cash flow generating ability.

A company with energy utility operations (i.e., electric distribution or transmission, natural gas distribution, oil and gas pipelines, regulated electric generation, or some combination of these) may also have operations in other segments of the energy industry (e.g., natural gas gathering and processing, field services, non-regulated electricity generation, etc.) and DBRS evaluates each of these business segments individually, as well as in the context of the business risk of the diversified company. Utility earnings and cash flows are generally considered much more stable and predictable than cash flows from non-regulated activities.

The following considerations more specifically characterize energy utilities and supplement the macro business and financial considerations, respectively, in Sections II and III of DBRS's methodology. All three sections, Sections II, III and IV, should be considered together.

PRIMARY FACTORS

Regulatory/Contractual

Regulatory and contractual factors are a key consideration in determining the creditworthiness of an energy utility. Provincial/state regulators typically have jurisdiction over utilities that operate in a single province/state. The federal regulator typically has jurisdiction over utilities where operations cross provincial/state boundaries.

Energy utilities typically operate under a methodology in which the regulator determines an appropriate capital structure for the regulated utility, and defines the allowed return on equity (ROE); these are two of the variables (along with depreciation, operating and maintenance costs, interest expense, etc.) that go into building up a utilities revenue requirement through a "bottom-up" approach. Variations of this method can provide the regulated utility with the opportunity to earn "excess" returns based on performance-based regulation (PBR) or incentive-tolling models that could incorporate some volume risk.



Alternatively, operations could be governed by long-term contracts (e.g., for pipelines or power generation) that reduce or eliminate volume and/or price risk for a fixed but potentially long period of time.

The extent of volume variance and fuel-price flow-through protection are also key factors in regulatory analysis. DBRS also considers whether the regulatory framework is flexible and responsive to changing industry conditions (e.g., timeliness of commodity price pass-through decisions where applicable, or changing ROE requirements).

However, being a utility does not assure income stability. There are many examples of regulatory lag which can slow cost recovery and negatively impact a firm's performance, particularly in the areas of fuel cost recovery and multi-year capital expenditure programs.

Capital Spending

Energy utilities are capital intensive businesses. An energy utility might undertake large capital projects in order to either meet growing demand in a high-growth franchise area, or to significantly refurbish aging assets. This could potentially lead to cost overruns and weaker financial metrics, at least during the growth phase.

All things being equal, a large multi-year growth project would likely entail more execution risk and credit metric deterioration than a small project with a shorter construction period. For larger multi-year projects, credit metric deterioration is largely attributable to the fact that while debt would typically be used to (at least partially) fund expenditures, cash earnings are generally not realized until the assets are placed in service. Therefore, the existing asset base must produce the cash required to service the incremental debt associated with the new assets until those assets are placed in service. If construction-related interest expense is capitalized, this can understate an entity's interest expense on the income statement as the capitalized portion is removed to arrive at the net interest expense.

DBRS also considers how tolls are impacted by new capital spending in the oil and gas pipeline segment. Under "rolled-in" tolls, capital and operating costs of new facilities are added to existing facilities, with existing and new shippers paying a toll designed to recover the cost of service of the combined facilities. This contrasts with "incremental" tolls wherein the incremental capital and operating costs of new facilities remain separate from existing facilities, with existing shippers paying a toll based on existing facilities, and shippers on the new facilities paying a toll reflecting the costs of those new facilities.

Other key aspects of capital spending analysis include the cash flow adequacy to finance ongoing necessary maintenance requirements, and the extent of a company's flexibility to alter the timing of projects. Capital spending analysis provides an understanding of a company's operating strategies, growth plans and areas under active investment and divestment.

Competitive Environment

Historically, Canadian energy utilities have operated as monopolies within their service areas. In order to mitigate market power concerns, pricing decisions are determined in conjunction with the appropriate regulator, with input also received from interested parties (e.g., customers). Competitive pressures tended to come from alternative sources of energy rather than alternative suppliers.

This has changed moderately in the Canadian oil and gas pipeline segment in recent years, and consequently being the lowest-cost alternative to transport product into a given end-user market is a competitive advantage when long-term take-or-pay contracts are not in place. By contrast, U.S. pipeline competition has been much more intense due to the significantly larger number of alternative routes to end-user markets. Consequently, some U.S. pipelines discount their tolls in order to attract volumes that might otherwise be shipped on a competitive pipeline. Despite the moderate increase in competition in the Canadian pipeline sector, DBRS still views the Canadian pipeline sector as having less exposure to competitive forces than their U.S. counterparts.



Supply/Demand Considerations

The provision of energy utility services depends on the presence of adequate supplies of energy (e.g., crude oil, natural gas, electricity) to meet end-user demand. In the case of pipelines, recoverable oil and gas reserves are required at one end of the pipeline and an adequate end-user market, or take-away capacity, are required at the other end of the pipeline. The degree to which pipeline capacity is utilized depends upon the degree of success of oil and gas producers' drilling results and their ability to tie in production to the pipeline. Seasonality of demand can also result in volume fluctuations.

For electric utilities, generation of sufficient electricity to meet demand is paramount. In Canada, the limited degree of inter-connection between provinces results in a limited role for purchased power. This is less of an issue in the United States.

Extent of Non-Utility Activities

Non-utility operations typically entail accepting additional business risk for higher potential financial returns. Non-utility operations typically include non-regulated electricity generation, field services, energy marketing and trading, oil and gas exploration and production.

Non-regulated activities must be evaluated on their own merits. This evaluation typically involves the competitive factors in each segment, as well as an assessment of how each individual segment contributes to the operations of the entire company. For example, a company with its own infrastructure (e.g., natural gas production, gathering and processing, transmission, distribution and electricity generation) would be in a much better position to derive value (and mitigate risk) along the entire energy value chain than would a company with stand-alone operations in any one area. In addition, given the higher business risk inherent in non-regulated activities, companies with larger exposures to non-regulated activities would be expected to maintain lower financial risk (i.e., lower balance sheet leverage and higher coverage ratios) as a compensating factor in order to have a comparable credit rating.

Business Mix and Diversification

For the electric-related utilities, there are three broad business areas: generation, transmission and distribution. Some utilities are fully integrated and participate in all three, while others may be involved in one or two segments. Generally, DBRS views transmission as the area with the least business risk, followed very closely by distribution, followed by generation. Within the electric generation segment, the type of facility (nuclear, coal, natural gas, hydroelectric, wind, etc.) also factors into the determination of business risk; for example nuclear generation is viewed as having the highest level of operating risk, with hydroelectric the lowest.



SECONDARY FACTORS

Customers/Shippers

With respect to the distribution of electricity and natural gas, customer mix can have implications for the degree to which the entity has volume exposure due to weather (residential and commercial customers) and economy-related (largely industrial customers) risks.

Typically, pipelines are available for either general industry service (covered by a regulatory framework) or for dedicated shippers (covered by long-term contracts). In the latter case, pipelines typically rely on contractual arrangements with particular shippers for a significant proportion of their revenues. In these cases, counterparty risk is key, as defaulted commitments might have to be replaced with shorter-term arrangements with less favourable terms, resulting in lower earnings.

Electric generation not subject to regulation operates on a commercial basis as either merchant (i.e., full price and volume risk) or enters into some type of contractual off-take or hedging arrangement. Similar to the pipelines, counterparty risk is critical for those with contractual or hedging arrangements.

Ownership

An energy utility's ownership can be an issue, particularly in the United States, where regulatory protection tends to be weaker than in Canada. An energy utility owner that is experiencing financial difficulties in its other operations might be tempted to use regulated assets to shore up its other operations, thereby weakening the financial position of the regulated energy utility.

Environmental Issues

DBRS assesses the extent to which energy utilities face government laws and regulations that can have an impact on a company's business and prospects. Regulated utilities may either be a direct source of greenhouse gas emissions (e.g., thermal power producer) or may transport energy derived from sources that produces emissions (e.g., carbon dioxide generated through oil and gas production). In light of the global push towards lower emissions, while the form of control is not known, DBRS views this risk and its associated cost as growing over time, although likely to be passed on to the end customers. There are a number of alternative solutions that could be put in place, including cap and trade, carbon taxation, direct emissions limits, or, in the electric generation sector, renewable energy portfolio standards.

Retail Exposure

Participants in the retail sector of the electricity industry who do not own generating assets can be exposed to significant market risk depending upon commercial arrangements, hence the key areas of analysis include hedging policies, counterparty risk and the size of the operation.

Political Risk

Energy utilities are essential service providers that have an impact on the general economy and society as a whole. As such, while it does not typically occur on a frequent basis, there is always the risk of political interference, which is distinct from regulatory risk. This has been seen in the past pertaining to such areas as overall market structures, environmental considerations and energy costs.

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