# Union Gas Limited

## 2013 Cost of Service Application

## Adopted Evidence Package

## EB-2011-0210

Shared Savings Mechanism Variance Account (Deferral Account No. 179-115) which will be closed upon the clearance of the 2011 balance in Union's 2011 deferral disposition proceeding in 2012.

Cross Bore Safety Program

Union requests the establishment of a deferral account to capture the variance between the amount of costs related to Union's Cross Bore Safety Program included in rates and the amount actually spent in 2012.

Transition to US GAAP – Pension

Union is transitioning its accounting and reporting standards to US Generally Accepted Accounting Principles ("US GAAP") beginning January 1, 2012. The US GAAP standard for reporting on pensions is ASC 715 *Compensation – Retirement Benefits* and results in a different pension expense than the Canadian GAAP standard (CICA 3461 *Employee Future Benefits*) currently used by Union. Reporting under US GAAP is familiar to Union as it is currently required to report using this standard to its parent company (Spectra Energy Corp).

On transition to US GAAP, a charge to retained earnings will result due to amounts that would have been previously recognized through pension expense had Union been reporting in US GAAP historically. The charge to retained earnings is made up of two components: a change in measurement date from September 30 to December 31, and a write off of unrecognized actuarial losses that were established upon the implementation of CICA 3461. At the time of transition to CICA 3461, unrecognized actuarial losses were established and amortized over the expected average remaining service life of the plan employees at that time. These unrecognized actuarial losses would have been fully amortized under US GAAP.

Under Canadian GAAP, the amount to be charged to retained earnings would have been charged to earnings through pension expense. Union's regulatory accounting, reporting and approved rates are based on the Canadian GAAP pension expense. If these amounts are charged to retained earnings, they will not be recognized as pension expense in utility earnings to be recovered from rate payers.

Union requests a deferral account to record as a debit the amount recognized in retained earnings associated with transitioning accounting standards and reporting to US GAAP for previously unrecorded pension expenses.

Union proposes to dispose the deferral balance through its annual deferral disposition proceeding.

**UNION GAS LIMITED**

**Accounting Entries for**
**Pension Charge on Transition to US GAAP**
**Deferral Account No. 179-127**

Account numbers are from the Uniform System of Accounts for Gas Utilities, Class A prescribed under the Ontario Energy Board Act.

| | | |
|---|---|---|
| Debit | - | Account No. 179-127<br>Other Deferred Charges – Pension Charge on Transition to US GAAP |
| Credit | - | Account No. 212<br>Retained Earnings |

To record, as a debit in Deferral Account No. 179-127, the amount recognized in retained earnings associated with transitioning accounting standards and reporting to US Generally Accepted Accounting Principles (GAAP) for previously unrecorded pension expenses.

| | | |
|---|---|---|
| Debit | - | Account No. 179-127<br>Other Deferred Charges - Pension Charge on Transition to US GAAP |
| Credit | - | Account No. 323<br>Other Interest Expense |

To record, as a debit (credit) in Deferral Account No. 179-127, interest on the balance in Deferral Account No. 179-127. Simple interest will be computed monthly on the opening balance in the said account at the short term debt rate as approved by the Board in EB-2006-0117.

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Ex. A / Tab 1 / Page 18
Addendum to the Report of the Board – Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment

Preamble:

On page 19 of the Addendum to the Report of the Board regarding Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment, the Board states that:

> The Board must consider the general public interest in ensuring efficiency and consistency in utility regulation in Ontario, and **will require utilities to explain the use of an accounting standard other than MIFRS for regulatory purposes**.
>
> A utility, in its first cost of service application following the adoption of the new accounting standard, **must demonstrate the eligibility of the utility under the relevant securities legislation to report financial information using that standard**, include a copy of the authorization to use the standard from the appropriate Canadian securities regulator (if applicable) showing any conditions or limitations, **and set out the benefits and potential disadvantages** to the utility and its ratepayers of using the alternate accounting standard for rate regulation.
>
> The Board cautions utilities that the adoption of USGAAP as a short term solution may be counter-productive. If a utility is required to transition to IFRS for financial reporting purposes a few years after adopting USGAAP, certain transitional issues may not have been avoided, but delayed, and additional costs may be incurred if the utility changes its accounting standard twice. **The Board will carefully scrutinize the costs incurred to accomplish two successive transitions if the utility seeks to recover these costs from ratepayers**.
>
> In addition, the Board emphasizes to utilities that it retains the authority to require specific accounting standards and practices for regulatory purposes in any case where the Board finds that the

> public interest requires uniformity in those standards and practices among utilities. (Emphasis Added)

Union stated that it is transitioning its accounting and reporting standards to US General Accepted Accounting Principles ("US GAAP") beginning January 1, 2012. Union explained that the benefit of transitioning to US GAAP is that US GAAP is familiar to Union as it is currently required to report using this standard to its parent company (Spectra Energy Corp).

a) Union is requesting a deferral account for pensions in relation to the transitioning to US GAAP in its 2012 IRM rate application, which indicates that it is Union's intention to use US GAAP for ratemaking purposes. Given the Board has outlined a number of requirements in the Addendum to the Report of the Board regarding the use of an accounting standard other than MIFRS (US GAAP in this case) for rate making purpose, these requirements need to be addressed before the Board can consider a deferral account to hold the differences resulting from the transitioning to US GAAP:

    i) Please file a copy of the Application made by Union to the relevant Canadian securities regulator requesting authorization to use US GAAP.

    ii) Please provide a copy of the authorization for Union to use US GAAP from the appropriate Canadian securities regulator showing any conditions or limitations.

    iii) What is the expiry date for the authorization to use US GAAP?

    iv) What are Union's plans with respect to financial and regulatory accounting upon the expiry of the authorization to use US GAAP?

    v) Please provide a detailed explanation of the benefits and potential disadvantages to the utility and especially to its ratepayers of using US GAAP instead of MIFRS for ratemaking purpose. Please include a discussion and details of the rate impact of the switch to US GAAP.

b) Given Union is transitioning to US GAAP instead of IFRS, please provide Union's detailed plan to address the following:

    i) the IFRS transition costs in deferral account 179-120, which Union requested for disposition in its Deferral Account and ESM rate application EB-2011-0038;

    ii) the transition costs to US GAAP;

iii) the plan for transition to IFRS upon the expiry of the authorization from a Canadian Securities regulator to use US GAAP;

iv) the transition costs to IFRS that may incur in subsequent years, if conversion from US GAAP to IFRS occurs.

c) Please indicate whether Union proposes to record carrying charges in relation to the amounts recorded in the applied for deferral account, and if so, why this would be appropriate and what rate of interest will be used.

d) What events does Union view as being necessarily precedent for the disposition of the US GAAP – Pensions Account? Please discuss the accounting standards, the accounting rule-making authorities, and the decisions of securities and energy regulators, that are relevant to both the Canadian and US situations.

e) Please indicate when Union will request the disposition of the account balance and the period over which Union proposes to recover the balance recorded in the deferral account from ratepayers.

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**Response:**

a) Union is not proposing to use US GAAP for ratemaking purposes in 2012. The proposal to use US GAAP for ratemaking will be included in Union's rebasing application. The purpose of the proposed deferral account is to capture the cost difference between Canadian and US GAAP as a regulatory asset that will be amortized to adjust the US GAAP employee future benefits costs to the level that would have otherwise been expensed under Canadian GAAP.

i. Please see Attachments 1 and 2.
ii. Please see Attachment 3.
iii. The exemption is effective until January 1, 2015
iv. Union's plans with respect to financial and regulatory accounting upon expiry of the exemption will depend upon the status of the convergence of US GAAP to IFRS. If the accounting standards are converged, no further exemption will be required. In the situation where the accounting standards are not converged, Union will examine the facts and circumstances at that time to determine if Union will request to extend the exemption.
v. Using US GAAP for ratemaking is not significantly different than the current Canadian GAAP. The only ratepayer issue to be addressed in the conversion from Canadian GAAP to US GAAP is the employee future benefits costs. The

transition to IFRS would result in a significantly larger adjustment for employee future benefits costs as well as additional adjustments for overheads capitalized, the inclusion of non legal asset removal costs in depreciation expense and the treatment of gains and losses on the disposition of assets. A detailed explanation of the transition to US GAAP is provided at Attachment 4.

A draft reconciliation of Union's consolidated balance sheet as at January 1, 2011 is provided at Attachment 5. A draft schedule detailing the differences in employee future benefits at January 1, 2011, the differences in 2011 net periodic benefit cost is provided at Attachment 6.

b)

i. Union will continue to seek recovery of the IFRS transition costs approved by the Board in EB-2010-0039.
ii. Union has incurred costs associated with the application to the securities administrators for exemptive relief. These costs are not material and have been expensed in 2011. Any additional costs by Union will be expensed in 2011 or 2012 as they are incurred.
iii. Please see the responses at a) part iii) and iv)
iv. It is not Union's plan to convert to IFRS in the future unless IFRS is converged with US GAAP. The convergence of US GAAP to IFRS will happen over time as standards are changed. Any costs associated with changes in accounting standards are not expected to be material. In the circumstance where costs of conversion are material Union would seek recovery through a Z factor adjustment to rates.

c) Union is not proposing to record carrying charges on amounts recorded in the proposed deferral account for employee future benefits. The Accounting Order submitted with Union's application incorrectly included interest charges. A new Accounting Order without interest charges will be submitted with the Rate Order.

d) Resetting rates based on US GAAP will trigger the requirement to address the recovery of the remaining deferral account balance. As long as rates are based on Canadian GAAP Union will amortize costs of the deferral account balance for accounting to adjust the US GAAP expense to the amount that would have otherwise been expensed under Canadian GAAP.

e) Union will request the disposition of the balance in the proposed deferral account as part of the annual disposition of the 2012 deferral account balances. The period of recovery is normally as a one-time adjustment (contract rate classes) or prospectively over several months (general service rate classes).

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March 24, 2011

British Columbia Securities Commission
701 West Georgia Street
P.O. Box 10142, Pacific Centre
Vancouver, British Columbia V7Y 1L2

**Attention: Martin Eady, Director, Corporate Finance**

Ontario Securities Commission
20 Queen Street West, Suite 1903
Toronto, Ontario M5H 3S8

**Attention: Leslie Byberg, Director, Corporate Finance**

Dear Sirs:

**Re: Application for Exemptions from Requirement to Prepare Financial Statements under IFRS**

We are counsel to Westcoast Energy Inc. ("**Westcoast**") and Union Gas Limited ("**Union Gas**") (collectively, the "**Filers**"). The Filers are each wholly-owned subsidiaries of Spectra Energy Corp ("**Spectra Energy**"), a U.S. based company that is an SEC Issuer (as defined below).

We hereby apply on behalf of Westcoast and Union Gas to the British Columbia Securities Commission (the "**BCSC**") and the Ontario Securities Commission (the "**OSC**") for a decision under section 5.1 of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards* ("**NI 52-107**") exempting each of the Filers from the requirements in NI 52-107 that financial statements of Rate Regulated Entities (as defined below) for financial years beginning on or after January 1, 2012 be prepared in accordance with IFRS (as defined below) and, when required, audited in accordance with Canadian GAAS (as defined below) and permitting the financial statements of each of the Filers to be prepared in accordance with U.S. GAAP (as defined below) and audited in accordance with U.S. GAAS (as defined below) (the "**Relief**").

The application on behalf of Westcoast is being made as a dual application within the meaning of National Policy 11-203 *Process for Exemptive Relief Applications in Multiple Jurisdictions* ("**NP 11-203**"). The BCSC has been selected as the principal regulator for this application on the basis that Westcoast's head office is located in British Columbia. Westcoast hereby gives notice that it is relying on section 4.7(1) of Multilateral Instrument 11-102 *Passport System* ("**MI-11-102**") in the provinces of Alberta, Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland. All factual information related to Westcoast and Spectra Energy contained herein has been provided to us by Westcoast.

The application on behalf of Union Gas is being made as a passport application within the meaning of NP 11-203. The OSC has been selected as the principal regulator for this application on the basis that Union Gas' head office is located in Ontario. Union Gas hereby gives notice that it is relying on section 4.7(1) of MI 11-102 in the provinces of British Columbia, Alberta, Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland (collectively, together with Ontario, the "**Jurisdictions**"). All factual information related to Union Gas contained herein has been provided to us by Union Gas.

We previously had discussions with Carla-Marie Hait, Chief Accountant of the BCSC, in December 2010 and January 2011 regarding accounting issues for Rate Regulated Entities under IFRS and possible alternatives potentially available to the Filers to convert to US GAAP instead of adopting IFRS.

## 1. Information About Westcoast

(a) Westcoast's head office is located at #1100, 1055 West Georgia Street, Vancouver, British Columbia.

(b) Westcoast is a corporation existing under the *Canada Business Corporations Act*.

(c) Westcoast is a reporting issuer or equivalent in each of the provinces of Canada and, to its knowledge, is not in default of securities legislation in any of such jurisdictions.

(d) Westcoast is an indirect wholly-owned subsidiary of Spectra Energy. Westcoast indirectly owns all of the outstanding common shares of Union Gas.

(e) Westcoast owns and operates facilities and businesses relating to natural gas gathering, processing, transmission, storage and distribution. Westcoast provides natural gas gathering, processing and mainline transmission services to customers in western Canada and the U.S. Pacific Northwest, through its interest in Maritimes & Northeast Pipeline LP, mainline transmission services to customers in the Maritimes and U.S. Northeast and, through Union Gas, natural gas storage, transmission and distribution services to customers in Ontario.

(f) At December 31, 2010, Westcoast (including Union Gas) had total consolidated assets of approximately $12.0 billion and total consolidated common shareholders' equity of approximately $3.1 billion, representing approximately 45% and 40% of Spectra Energy's total consolidated assets and total consolidated shareholders' equity (controlling interest), respectively.

(g) Westcoast's authorized share capital consists of (i) an unlimited number of common shares, all of the outstanding shares of which are indirectly owned by Spectra Energy, (ii) an unlimited number of first preferred shares, issuable in series from time to time, of which 6,000,000 5.50% Cumulative First Preferred Shares, Series 7 and 6,000,000 5.60% Cumulative First Preferred Shares, Series 8 (collectively, the "**Westcoast Preferred Shares**") are outstanding, and (iii) an unlimited number of second preferred shares, issuable in series from time to time, of which 50,000 6.75% Cumulative Redeemable Retractable Second Preferred Shares, Series B are outstanding (all of which are indirectly owned by Spectra Energy).

None of the Westcoast Preferred Shares are convertible into common shares of Westcoast or exchangeable for equity securities of any other issuer.

None of the Westcoast Preferred Shares are "voting securities" (as defined in the securities legislation of the Jurisdictions).

The Westcoast Preferred Shares carry investment grade ratings by Standard & Poor's Ratings Services ("**S&P**") (P-2 (low)) and DBRS Limited ("**DBRS**") (Pfd-2 (low)).

The Westcoast Preferred Shares are listed on the Toronto Stock Exchange ("the **TSX**").

(h) At February 28, 2011, Westcoast had publicly-held debt outstanding (the "**Westcoast Debt Securities**") consisting of (i) $750 million aggregate principal amount of debentures and (ii) $1.2 billion aggregate principal amount of medium term notes.

None of the Westcoast Debt Securities are convertible into or exchangeable for equity securities of any issuer.

The Westcoast Debt Securities carry investment grade ratings by S&P (BBB+) and DBRS (A (low)).

(i) Westcoast is engaged in rate-regulated activities and is a "qualifying entity" (as defined in subsection 5.4(2) of NI 52-107) (a "**Rate Regulated Entity**"). As a Rate Regulated Entity, Westcoast has elected to use the one year deferral approved by the Canadian Accounting Standards Board (the "**AcSB**") in September 2010 (as recognized in section 5.4 of NI 52-107) to continue to prepare its financial statements in accordance with Canadian GAAP – Part V (as defined in subsection 4.1(1) of NI 52-107) ("**Canadian GAAP**") during the 2011 deferral period instead of adopting generally accepted accounting principles determined with reference to Part I – International Financial Reporting Standards of the Handbook (as defined in National Instrument 14-101 *Definitions* ("**NI 14-101**")) ("**IFRS**").

Pursuant to each of Canadian GAAP, IFRS and U.S. GAAP, the financial statements of Union Gas must be consolidated into the financial statements of Westcoast.

(j) Westcoast is not an SEC issuer (as defined in section 1.1 of NI 52-107) ("**SEC Issuer**").

## 2. Information About Union Gas

(a) Union Gas' head office is located at 50 Keil Drive North, Chatham, Ontario.

(b) Union Gas is a corporation existing under the *Business Corporations Act* (Ontario).

(c) Union Gas is a reporting issuer or equivalent in each of the provinces of Canada and, to its knowledge, is not in default of securities legislation in any such jurisdictions.

(d) Union Gas is an indirect wholly-owned subsidiary of Westcoast.

(e) Union Gas owns and operates facilities and provides services to customers in Ontario relating to natural gas storage, transmission and distribution.

(f) At December 31, 2010, Union Gas had total consolidated assets of approximately \$5.6 billion and total consolidated shareholders' equity of approximately \$1.4 billion, representing approximately 21% and 18% of Spectra Energy's total consolidated assets and total consolidated shareholders' equity (controlling interest), respectively.

(g) Union Gas' authorized share capital consists of (i) an unlimited number of common shares, all of the outstanding shares of which are indirectly owned by Westcoast, (ii) 202,072 Class A Preference Shares, issuable in series from time to time, of which 47,672 5.50% Cumulative Redeemable Class A Preference Shares, Series A and 90,000 6.0% Cumulative Redeemable Class A Preference Shares, Series B (collectively, the "**Union Gas Class A Preference Shares, Series A and B**") and 49,500 5% Cumulative Redeemable Class A Preference Shares, Series C (together with the Union Gas Class A Preference Shares, Series A and B, the "**Union Gas Class A Preference Shares**") are outstanding, (iii) an unlimited number of Class B Preference Shares, issuable in series from time to time, of which 4,000,000 4.88% Cumulative Redeemable Convertible Class B Preference Shares, Series 10 (the "**Union Gas Class B Preference Shares**" and, together with the Union Gas Class A Preference Shares, the "**Union Gas Preference Shares**") are outstanding, and (iv) an unlimited number of Class C Preference Shares, issuable in a series from time to time, none of which are outstanding.

None of the Union Gas Preference Shares are convertible into common shares of Union Gas or exchangeable for equity securities of any other issuer.

None of the Union Gas Preference Shares are voting securities.

The Union Gas Preference Shares carry investment grade ratings by S&P (P-2 (low)) and DBRS (Pfd-2).

The Union Gas Class A Preference Shares, Series A and B are listed on the TSX.

(h) At February 28, 2011, Union Gas had publicly-held debt outstanding (the "**Union Gas Debt Securities**") consisting of (i) \$750 million aggregate principal amount of debentures and (ii) \$1.5 billion aggregate principal amount of medium term notes.

None of the Union Gas Debt Securities are convertible into or exchangeable for equity securities of any issuer.

The Union Gas Debt Securities carry investment grade ratings by S&P (BBB+) and DBRS (A).

(i) Union Gas is a Rate Regulated Entity and, similarly to Westcoast, has elected to use the one year deferral approved by the AcSB to continue to prepare its financial statements in accordance with Canadian GAAP during the 2011 deferral period instead of adopting IFRS.

(j) Union Gas is not an SEC Issuer.

## 3. Information about Spectra Energy

(a) Spectra Energy's head office is located at 5400 Westheimer Court, Houston, Texas.

(b) Spectra Energy is incorporated under the laws of Delaware.

(c) Spectra Energy's common shares are listed on the New York Stock Exchange and registered with the U.S. Securities and Exchange Commission (the "**SEC**") under the U.S. *Securities Exchange Act of 1934*, as amended (the "**1934 Act**").

Spectra Energy is a reporting issuer in Quebec[1] and, to its knowledge, is not in default of securities legislation in such jurisdiction.

(d) Spectra Energy, through its subsidiaries and equity affiliates, owns and operates a large and diversified portfolio of complementary natural gas related energy assets and is one of North America's leading natural gas infrastructure companies.

(e) The market capitalization of Spectra Energy's common shares is currently approximately US$ 17 billion.

At December 31, 2010, Spectra Energy had total consolidated assets of approximately US$ 26.7 billion and total consolidated shareholders' equity (controlling interest) of approximately US$ 7.8 billion.

Spectra Energy operates in four reportable segments. One of these segments, Distribution, comprises Union Gas' facilities and operations and another, Western Canada Transmission & Processing, comprises a significant portion of Westcoast's other (non-Union Gas) operations.[2] For the year ended December 31, 2010, the Distribution and Western Canada Transmission & Processing segments represented approximately 36% and 27%, respectively, of

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1 This status relates to an exchangeable share entity, Spectra Energy Canada Exchangeco Inc., that was created in connection with the acquisition of Westcoast in 2002 by a predecessor of Spectra Energy. This entity has ceased to be a reporting issuer in any Jurisdiction.

2 The Western Canada Transmission & Processing segment does not include Westcoast's operations in the Maritime Provinces.

Spectra Energy's total consolidated operating revenues and each of these segments represented approximately 19% of Spectra Energy's total reportable segment EBIT.[3]

(f) Spectra Energy's financial statements are prepared in accordance with U.S. GAAP (as defined in section 1.1 of NI 52-107) and its annual financial statements are audited in accordance with U.S. PCAOB GAAS (as defined in section 1.1 of NI 52-107) ("**U.S. GAAS**").

Pursuant to U.S. GAAP, the financial statements of Westcoast and Union Gas must be consolidated into the financial statements of Spectra Energy.

## 4. Requested Relief

(a) The Filers are requesting a decision pursuant to section 5.1 of NI 52-107 exempting each of the Filers from the requirements of section 3.2 of NI 52-107, as applied in accordance with section 5.4 of NI 52-107, including the requirement that financial statements of Rate Regulated Entities for financial years beginning on or after January 1, 2012 must be prepared in accordance with IFRS, and permitting the financial statements of each of the Filers to be prepared in accordance with U.S. GAAP, provided that the financial statements of such Filer continue to be consolidated into the financial statements of Spectra Energy.

(b) The Filers are requesting a decision pursuant to section 5.1 of NI 52-107 exempting each of the Filers from the requirements of section 3.3 of NI 52-107, as applied in accordance with section 5.4 of NI 52-107, including the requirement that financial statements of Rate Regulated Entities for financial years beginning on or after January 1, 2012 that are required by securities legislation to be audited must be audited in accordance with Canadian GAAS (as defined in NI 14-101), and permitting the financial statements of each of the Filers to be audited in accordance with U.S. GAAS, provided that the financial statements of such Filer continue to be consolidated into the financial statements of Spectra Energy.

## 5. Reasons for Application

IFRS currently does not adequately provide for accounting for rate-regulated activities. Adoption of IFRS by Westcoast and Union Gas at this time will create significant uncertainty in their financial reporting and have a substantial impact on their financial results at the time of adoption. U.S. GAAP provides a well-recognized, accepted and comprehensive basis of accounting for rate-regulated activities that is substantially similar to Canadian GAAP and will provide the Filers and their investors and other stakeholders with consistency that reflects the economic realities of these activities.

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3 Segment EBIT is a non-GAAP measure used by Spectra Energy to report segment results and is the primary performance measure used by Spectra Energy to evaluate segment performance. At the segment level EBIT represents earnings from continuing operations (both operating and non-operating) before interest and taxes, net of non-controlling interests related to those earnings.

## 6. Submissions

(a) Westcoast and Union Gas currently prepare their financial statements using Canadian GAAP. Spectra prepares its financial statements using U.S. GAAP. Canadian GAAP and U.S. GAAP each include similar specific principles for accounting for the effects of rate regulation.

Significant portions of the Filers' operations are subject to regulation by various authorities. Regulatory authorities exercise statutory authority over matters such as construction, rates and ratemaking, and agreements with customers. To recognize the economic effects of the actions of the regulators, the timing of recognition of certain revenues and expenses in operations may differ from that otherwise expected under Canadian GAAP for non-Rate Regulated Entities. Under Canadian GAAP, the Filers record regulatory assets and liabilities to recognize the economic effects of the actions of the regulators. Regulatory assets represent amounts that are expected to be recovered from customers in future periods through rates. Regulatory liabilities represent amounts that are expected to be refunded to customers in future periods through rates. On recovery or refund of this difference, no earnings impact is recorded. Effectively, the income statement captures only the approved costs and the related revenue rather than the actual costs and related revenue. Spectra Energy applies the same principles under U.S. GAAP.

These principles for accounting for rate-regulated activities have been well-established for a long time[4] and are recognized and accepted as the most appropriate framework for treating these activities by investors, analysts, credit rating agencies, regulators and other stakeholders.

Rate regulation pervasively affects a substantial portion of the Filers' operations and is central to each Filer's business model and performance measurement. At December 31, 2010, Westcoast's (non-Union Gas) regulatory assets and regulatory liabilities totalled approximately $604 million and $7 million, respectively, and Union Gas' regulatory assets and regulatory liabilities totalled approximately $257 million and $488 million, respectively.

(b) Unlike Canadian GAAP and U.S. GAAP, IFRS does not currently include specific guidance on accounting for rate-regulated activities. In December 2008, the International Accounting Standards Board (the "**IASB**") decided to undertake a project to develop a standard on rate-regulated activities. In July 2009, the IASB issued an Exposure Draft, *Rate-regulated Activities*, which proposed a standard that would have permitted the recognition of regulatory assets and liabilities in some circumstances, similar to practice under Canadian GAAP. The IASB subsequently redeliberated its proposals based on comments received on its Exposure Draft. At its July 2010 meeting, the IASB decided to continue work on its rate-regulated activities project as time and resources permitted, with a plan to issue a final standard in late 2011. The IASB also decided not to develop any transitional guidance for use by first-time adoptors of IFRS until a final standard is available. At its September 2010 meeting, the IASB did not reach conclusions

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4 For example, the U.S. Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS 71) was issued in 1982.

on any technical issues, confirmed that issues relating to this topic could not be resolved quickly and removed this project from its active agenda. The IASB decided to include in its 2011 public consultation on its future post-2011 agenda a request for views on what form a future project might take, if any.

As a result of the foregoing, there continues to be significant uncertainty as to when, and if, rate-regulated accounting under IFRS will be clarified.

(c) The AcSB recognized the magnitude of this uncertainty and its impact on Rate Regulated Entities. At its September 2010 meeting, the AcSB approved an amendment to the Handbook to provide an optional deferral of the mandatory date for adoption of IFRS by Rate Regulated Entities. The AcSB decided that the deferral should last for one year only, until 2012, regardless of future IASB activities on rate-regulated accounting issues. At its October 2010 meeting, the AcSB considered requests and suggestions from stakeholders to extend the deferral period or develop an interim solution through new Handbook guidance. The AcSB rejected these requests and suggestions. It concluded that an additional year should provide sufficient time for Rate Regulated Entities to complete their preparation for adopting IFRS despite the IASB's decision to abandon its project. The AcSB also expressly noted that eligible entities, as an alternative, could decide during the deferral period to adopt U.S. GAAP in place of IFRS.[5]

The Filers, and many other Rate Regulated Entities, elected to use the one year deferral to continue to prepare their financial statements in accordance with Canadian GAAP during 2011.

(d) Under IFRS, many of the regulatory assets and liabilities of Rate Regulated Entities may not meet the definition of an asset or liability upon implementation of IFRS. These assets and liabilities would be written off at implementation and the future economic effects of these types of items would be recognized in earnings of the period in which they occur.

The anticipated impact to Westcoast and Union Gas of the adoption of IFRS is a substantial retained earnings loss at the time of transition to IFRS and ongoing income statement volatility and uncertainty.

This would create confusion for the Filers' investors and other stakeholders and, unlike Canadian GAAP and U.S. GAAP, would not transparently reflect the actual economic effects of rate regulation.

Further confusion and additional complexity for the investment community would arise in the case of the Filers since two of Spectra Energy's reportable segments separately represent, in a transparent manner, the operations of Union Gas and the non-Union Gas operations of Westcoast. The operating results of these two segments, reported by Spectra Energy under U.S. GAAP, would differ significantly from the corresponding results reported by Westcoast and Union Gas under IFRS.

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5 See paragraph 14 of *Background Information and Basis for Conclusions: Adoption of IFRS by Entities with Rate-regulated Activities – Amendment to Introduction to Part I*, issued by the AcSB on December 15, 2010.

(e) Canadian companies that are SEC Issuers are permitted to use U.S. GAAP and U.S. GAAS, instead of IFRS and Canadian GAAS, under sections 3.7 and 3.8 of NI 52-107. U.S. GAAP financial statements are not required by NI 52-107 to be reconciled to Canadian GAAP. NI 52-107 recognizes that Canadian GAAP and U.S. GAAP have become closely aligned and that, with the increasing integration of the Canadian and U.S. capital markets, the Canadian investment community has become comfortably familiar with U.S. GAAP.

The Westcoast Debt Securities, the Westcoast Preferred Shares, the Union Gas Debt Securities and the Union Gas Preference Shares are all investment grade fixed income securities that are largely held by sophisticated institutional investors who would be accustomed to U.S. GAAP.

(f) NI 52-107 also recognizes that the U.S. GAAP financial statements of SEC Issuers are subject to review by the SEC. Although the Filers are not SEC Issuers, they are wholly-owned subsidiaries of Spectra Energy consolidated into its financial statements for reporting purposes, and Spectra Energy is an SEC Issuer. Westcoast and Union Gas each represent significant parts of Spectra Energy's consolidated operations and, as two of its four reportable segments, the relevant operating results of each are transparently presented and disclosed in Spectra Energy's financial statements and other continuous disclosure documents filed with the SEC. It is therefore reasonable to presume that financial information relating to the Filers would readily fall within the scope of customary SEC reviews of Spectra Energy's filings.

(g) The adoption of U.S. GAAP by the Filers would avoid the current uncertainty about the application of IFRS to rate-regulated activities, including uncertainty concerning the substantial one-time adjustments and implementation issues upon adoption and the possibility of future adjustments to IFRS financial statements based on the IASB's ultimate resolution of the issue.

Reporting under U.S. GAAP would also reduce the risk of accounting errors that would arise from adoption of IFRS because it would allow the application of one set of accounting standards among all of Spectra Energy's Canadian and U.S. operations. If IFRS is adopted by the Filers, substantial adjustments will be required to convert their IFRS prepared financial statements into U.S. GAAP for purposes of consolidation with Spectra Energy's financial statements. Westcoast and Union Gas will need to maintain at least two sets of accounting books, one for IFRS and one for U.S. GAAP, and significant reconciliations will be required between them, especially in light of the regulatory accounting differences between IFRS and U.S. GAAP standards. This will increase complexity for the Spectra Energy group, impact its controls structure and create the risk of error. Because of the close similarity of U.S. GAAP and Canadian GAAP, this issue was not significant in the past.

(h) The natural gas infrastructure industry is very capital intensive. The business of each Filer is financed to a significant degree through debt. The Filers each rely heavily on access to the capital markets as a source of liquidity for capital requirements.

Several of the Filers' key Canadian peers, including Enbridge Inc. and TransCanada Corporation and their respective affiliates, have publicly disclosed their intention or expectation to adopt U.S. GAAP instead of IFRS. Under IFRS, the Filers' financial results would no longer be readily comparable to their key peers, and this could adversely affect the ability of the Filers to access capital at competitive rates.

(i) A possible alternative for the Filers would be to each qualify as an SEC Issuer under NI 52-107 in order to enable them to prepare their financial statements in accordance with U.S. GAAP and audit their financial statements in accordance with U.S. GAAS. To become an SEC Issuer, Westcoast and Union Gas would have to register Westcoast Preferred Shares and Union Gas Preference Shares, respectively, with the SEC on Form 20-F under the 1934 Act[6]. The work that would be required for initial registration with the SEC on Form 20-F for Westcoast and Union Gas and ongoing reporting activities would be expected to be significant.

(j) Similar relief was recently granted in *Re Enbridge Inc.*, 2011 ABASC 106 (the "**Enbridge Decision**"). The relevant facts and circumstances in the Enbridge Decision were substantially similar to those set forth herein, except that, unlike the parent SEC Issuer in that decision ("**Enbridge Parent**"), Spectra Energy has been using U.S. GAAP since its inception and is a U.S. domestic issuer (not an MJDS issuer like Enbridge Parent) which is subject to customary regulatory review by the SEC.

The relief granted in the Enbridge Decision extends only until the financial year ending December 31, 2014. For subsequent years, the Enbridge affiliates ("**Enbridge Affiliates**") covered by the Enbridge Decision will be required to adopt IFRS. At that time, in order to enable a single set of accounting principles to be used throughout the Enbridge corporate group, Enbridge Parent, as a Canadian entity, will be afforded the flexibility of choosing to revert to IFRS from U.S. GAAP.

As a U.S. entity, Spectra Energy has no similar flexibility to change from U.S. GAAP in order to maintain one common set of accounting principles within its corporate group. We submit that in these circumstances it would be appropriate to grant the Relief requested herein without a sunset provision. Relief has been granted in the past in order to allow issuers to use a single set of accounting principles throughout a corporate group in order to reduce the cost and complexity of the financial statement preparation process.[7]

The Enbridge Decision also sets out three conditions: (i) Enbridge Parent must hold all of the equity securities of the Enbridge Affiliates, (ii) the Enbridge

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6 The SEC has recently proposed (Release No. 33-9186, February 9, 2011) to rescind Form F-9 as part of various proposed amendments to remove references to credit ratings in rules and forms under the 1934 Act as required under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Consequently, Canadian foreign private issuers with investment grade rated securities but no publicly held equity shares, like Westcoast and Union Gas, will no longer be eligible to register with, and report to, the SEC using Form 40-F under the Multi-Jurisdictional Disclosure System ("**MJDS**").

7 See, for example, *In the Matter of Brookfield Asset Management Inc.*, OSC August 25, 2008 and *In the Matter of Potash Corporation of Saskatchewan Inc.*, OSC August 6, 2010.

Affiliates must not issue any "exchange-traded securities" (as defined in section 1.1 of National Instrument 21-101 *Marketplace Operation*) and (iii) the Enbridge Affiliates' financial statements must continue to be consolidated into Enbridge Parent's financial statements. As noted in paragraphs 6(e) and (f) above, the policy rationale underlying the provisions in NI 52-107 which permit SEC Issuers to use U.S. GAAP recognizes that the Canadian investment community is familiar with U.S. GAAP and that the U.S. GAAP financial statements of SEC Issuers are subject to SEC review. We submit that the same policy rationale applies with respect to the Relief requested herein and that, accordingly, only the third condition in the Enbridge Decision (relating to continuing consolidation) has any relevance in the case of the Filers.

Without in any manner derogating from the foregoing, we submit that the use of exchange-traded securities as a triggering concept in the second condition in the Enbridge Decision was unintentionally cast too broadly. In the case of the Filers, the fact that the Westcoast Preferred Shares and the Union Gas Class A Preference Shares, Series A and B are listed on the TSX represents no discernable characteristic that in some manner merits notional protection for investors by requiring IFRS instead of U.S. GAAP prepared financial statements. Instead, the attributes of these securities which are in fact meaningfully relevant with respect to the Relief include that they are all investment grade fixed income securities which are neither equity securities nor voting securities.

(k) It would not be prejudicial to the public interest to grant the Relief.

7. **Documentation**

We enclose the following in connection with this application:

(a) a draft decision;

(b) verification statements; and

(c) copies of the Enbridge Decision and the decisions referred to in note 7 above.

If you require further information to assist you with your review of this application, please do not hesitate to contact the undersigned or Genevieve Pinto at (604) 643-7946.

Yours very truly,

**McCarthy Tétrault LLP**

Per:

Richard J. Balfour

•, 2011

In the Matter of
the Securities Legislation of
British Columbia and Ontario (the **Jurisdictions**)

and

In the Matter of
the Process for Exemptive Relief Applications in Multiple Jurisdictions

and

In the Matter of
Westcoast Energy Inc. and Union Gas Limited

Decision

## Background

The securities regulatory authority or regulator in each of the Jurisdictions (the **Decision Maker**) has received an application from the Filers for a decision under the securities legislation of the Jurisdictions (the **Legislation**) exempting Westcoast Energy Inc. (**Westcoast**) and Union Gas Limited (**Union Gas**), (collectively, the **Filers**) from the requirements of sections 3.2 and 3.3 of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards* (**NI 52-107**), including the requirements that that financial statements of Rate Regulated Entities (as defined below) for financial years beginning on or after January 1, 2012 be prepared in accordance with IFRS (as defined below) and, when required, audited in accordance with Canadian generally accepted auditing standards (**Canadian GAAS**), and permitting the financial statements of each of the Filers to be prepared in accordance with U.S. GAAP (as defined below) and audited in accordance with U.S. GAAS (as defined below) (the **Exemption Sought**).

Under the Process for Exemptive Relief Applications in Multiple Jurisdictions:

(a) the British Columbia Securities Commission is the principal regulator for the dual application of Westcoast and the Ontario Securities Commission is the principal regulator for the passport application of Union Gas;

(b) the Filers have provided notice that subsection 4.7(1) of Multilateral Instrument 11-102 *Passport System* (**MI 11-102**) is intended to be relied upon in Alberta, Saskatchewan, Manitoba, Québec, Nova Scotia, New Brunswick, Prince Edward Island and Newfoundland and Labrador with respect to Westcoast and in British Columbia, Alberta, Saskatchewan, Manitoba, Québec, Nova Scotia, New Brunswick, Prince Edward Island and Newfoundland and Labrador with respect to Union Gas (collectively with Ontario, the **Relevant Jurisdictions**); and

(c) the decision is the decision of the principal regulator and evidences the decision of the securities regulatory authority or regulator in Ontario with respect to the dual application of Westcoast.

## Interpretation

Terms defined in National Instrument 14-101 *Definitions*, MI 11-102 and NI 52-107 have the same meaning if used in this decision, unless otherwise defined.

## Representations

This decision is based on the following facts represented by the Filers:

*Westcoast*

1. Westcoast's head office is located at #1100, 1055 West Georgia Street, Vancouver, British Columbia.

2. Westcoast is a corporation existing under the *Canada Business Corporations Act*.

3. Westcoast is a reporting issuer or equivalent in each of the Relevant Jurisdictions of Canada and, to its knowledge, is not in default of securities legislation in any of such jurisdictions.

4. Westcoast is an indirect wholly-owned subsidiary of Spectra Energy Corp (**Spectra Energy**). Westcoast indirectly owns all of the outstanding common shares of Union Gas.

5. Westcoast's authorized share capital consists of (i) an unlimited number of common shares, all of the outstanding shares of which are indirectly owned by Spectra Energy, (ii) an unlimited number of first preferred shares, issuable in series from time to time, of which 6,000,000 5.50% Cumulative First Preferred Shares, Series 7 and 6,000,000 5.60% Cumulative First Preferred Shares, Series 8 (collectively, the **Westcoast Preferred Shares**) are outstanding, and (iii) an unlimited number of second preferred shares, issuable in series from time to time, of which 50,000 6.75% Cumulative Redeemable Retractable Second Preferred Shares, Series B are outstanding (all of which are indirectly owned by Spectra Energy).

6. None of the Westcoast Preferred Shares are convertible into common shares of Westcoast or exchangeable for equity securities of any other issuer.

7. None of the Westcoast Preferred Shares are "voting securities" (as defined in the securities legislation of the Relevant Jurisdictions).

8. The Westcoast Preferred Shares are listed on the Toronto Stock Exchange (the **TSX**).

9. At February 28, 2011, Westcoast had publicly-held debt outstanding (the **Westcoast Debt Securities**) consisting of (i) $750 million aggregate principal amount of debentures and (ii) $1.2 billion aggregate principal amount of medium term notes.

10. None of the Westcoast Debt Securities are convertible into or exchangeable for equity securities of any issuer.

11. Westcoast is engaged in rate-regulated activities and is a "qualifying entity" (as defined in subsection 5.4(2) of NI 52-107) (a **Rate Regulated Entity**). As a Rate Regulated

Entity, Westcoast has elected to use the one year deferral approved by the Canadian Accounting Standards Board in September 2010 (as recognized in section 5.4 of NI 52-107) to continue to prepare its financial statements in accordance with Canadian GAAP – Part V (as defined in subsection 4.1(1) of NI 52-107) (**Canadian GAAP**) during the 2011 deferral period instead of adopting generally accepted accounting principles determined with reference to Part I – International Financial Reporting Standards of the Handbook (as defined in National Instrument 14-101 *Definitions* (**NI 14-101**)) (**IFRS**).

12. Pursuant to each of Canadian GAAP, IFRS and U.S. GAAP, the financial statements of Union Gas must be consolidated into the financial statements of Westcoast.

13. Westcoast is not an "SEC issuer" as that term is defined in NI 52-107 (**SEC Issuer**).

*Union Gas*

14. Union Gas' head office is located at 50 Keil Drive North, Chatham, Ontario.

15. Union Gas is a corporation existing under the *Business Corporations Act* (Ontario).

16. Union Gas is a reporting issuer or equivalent in each of the Relevant Jurisdictions and, to its knowledge, is not in default of securities legislation in any such jurisdictions.

17. Union Gas is an indirect wholly-owned subsidiary of Westcoast.

18. Union Gas' authorized share capital consists of (i) an unlimited number of common shares, all of the outstanding shares of which are indirectly owned by Westcoast, (ii) 202,072 Class A Preference Shares, issuable in series from time to time, of which 47,672 5.50% Cumulative Redeemable Class A Preference Shares, Series A and 90,000 6.0% Cumulative Redeemable Class A Preference Shares, Series B (collectively, the **Union Gas Class A Preference Shares, Series A and B**) and 49,500 5% Cumulative Redeemable Class A Preference Shares, Series C (together with the Union Gas Class A Preference Shares, Series A and B, the **Union Gas Class A Preference Shares**) are outstanding, (iii) an unlimited number of Class B Preference Shares, issuable in series from time to time, of which 4,000,000 4.88% Cumulative Redeemable Convertible Class B Preference Shares, Series 10 (the **Union Gas Class B Preference Shares** and, together with the Union Gas Class A Preference Shares, the **Union Gas Preference Shares**) are outstanding, and (iv) an unlimited number of Class C Preference Shares, issuable in a series from time to time, none of which are outstanding.

19. None of the Union Gas Preference Shares are convertible into common shares of Union Gas or exchangeable for equity securities of any other issuer.

20. None of the Union Gas Preference Shares are voting securities.

21. The Union Gas Class A Preference Shares, Series A and B are listed on the TSX.

22. At February 28, 2011, Union Gas had publicly-held debt outstanding (the **Union Gas Debt Securities**) consisting of (i) $750 million aggregate principal amount of debentures and (ii) $1.5 billion aggregate principal amount of medium term notes.

23. None of the Union Gas Debt Securities are convertible into or exchangeable for equity securities of any issuer.

24. Union Gas is not an SEC Issuer.

*Spectra Energy*

25. Spectra Energy's head office is located at 5400 Westheimer Court, Houston, Texas.

26. Spectra Energy is incorporated under the laws of Delaware.

27. Spectra Energy's common shares are listed on the New York Stock Exchange and registered with the U.S. Securities and Exchange Commission (the **SEC**) under the U.S. *Securities Exchange Act of 1934*, as amended (the **1934 Act**).

28. Spectra Energy is a reporting issuer in the Province of Quebec and, to its knowledge, is not in default of securities legislation in such jurisdiction.

29. Spectra Energy's financial statements are prepared in accordance with U.S. GAAP and its annual financial statements are audited in accordance with U.S. PCAOB GAAS (as defined in section 1.1 of NI 52-107) (**U.S. GAAS**).

30. Pursuant to U.S. GAAP, the financial statements of Westcoast and Union Gas must be consolidated into the financial statements of Spectra Energy. The operations of each of Westcoast and Union Gas represent a material portion of the consolidated operations of Spectra Energy.

31. Spectra Energy is an SEC Issuer and can rely on subsection 3.7 of NI 52-107 to prepare and file with, or deliver to, a securities regulatory authority or regulator U.S. GAAP financial statements.

*General*

32. It was anticipated that an International Accounting Standards Board's (**IASB**) exposure draft would have provided direction regarding rate-regulated accounting under IFRS effective prior to the January 1, 2011 transition date to IFRS to assist Rate Regulated Entities with their IFRS transition. However, due to divergent views on rate-regulated accounting at the IASB, a rate-regulated accounting standard has not been finalized. There continues to be significant uncertainty as to when, and if, rate-regulated accounting under IFRS will be clarified.

33. Rate-regulated accounting is well established in the United States, including, for example, the U.S. Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (SFAS 71), which was issued in 1982. Spectra Energy has used U.S. GAAP and U.S. GAAS since its inception.

34. Canadian companies that are SEC Issuers are permitted to use U.S. GAAP and U.S. GAAS, instead of IFRS and Canadian GAAS, under sections 3.7 and 3.8 of NI 52-107.

U.S. GAAP financial statements are not required by NI 52-107 to be reconciled to Canadian GAAP.

35. The Filers are not SEC Issuers and cannot rely on sections 3.7 and 3.8 of NI 52-107. The Filers are wholly-owned subsidiaries of Spectra Energy consolidated into its financial statements for reporting purposes, and Spectra Energy is an SEC Issuer that uses U.S. GAAP and U.S. GAAS.

36. The Filers will certify their interim and annual U.S. GAAP financial statements by filing the appropriate certificates in accordance with National Instrument 52-109 *Certification of Disclosure*.

**Decision**

Each of the Decision Makers is satisfied that the decision meets the test set out in the Legislation for the Decision Maker to make the decision.

The decision of the Decision Makers under the Legislation is that the Exemption Sought is granted for the financial years commencing January 1, 2012 in respect of each Filer provided that the financial statements of such Filer continue to be consolidated into the financial statements of Spectra Energy.

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March 31, 2011

British Columbia Securities Commission
701 West Georgia Street
P.O. Box 10142, Pacific Centre
Vancouver, British Columbia V7Y 1L2

**Attention: Martin Eady, Director, Corporate Finance**

Ontario Securities Commission
20 Queen Street West, Suite 1903
Toronto, Ontario M5H 3S8

**Attention: Leslie Byberg, Director, Corporate Finance**

Dear Sirs/Mesdames:

**Re: Application for Exemptions from Requirement to Prepare Financial Statements under IFRS**

We are counsel to Westcoast Energy Inc. ("**Westcoast**") and Union Gas Limited ("**Union Gas**") (collectively, the "**Filers**") in respect of the Filers' application (the "**Application**") to the British Columbia Securities Commission (the "**BCSC**") and the Ontario Securities Commission (the "**OSC**") made on March 24, 2011.

Further to our discussions and email correspondence with George Hungerford of the BCSC on March 25, 2011 and March 30, 2011 we were requested to submit a formal request for the Application to be treated as a dual application to the BCSC as principal regulator in respect of both Filers.

The OSC is the principal regulator for Union Gas as its head office is located in Ontario. However, the Filers request that the BCSC be designated as the principal regulator for the Application because the BCSC is the principal regulator of Westcoast as its head office is in British Columbia and Union Gas is an indirect wholly-owned subsidiary of Westcoast. Please consider this a written request pursuant to section 3.7 of National Policy 11-203 - *Process for Exemptive Relief Applications in Multiple Jurisdictions* for a change in principal regulator in respect of Union Gas for this Application only.

We believe this request is consistent with the approach of the OSC and Alberta Securities Commission in the *Re Enbridge Inc.*, 2011 ABASC 106 decision, a copy of which was enclosed with the Application.

*101745-385673*
*DOCS #10245057 v. 1*

If you require further information to assist you with your review of this application, please do not hesitate to contact the undersigned or Genevieve Pinto at (604) 643-7946.

Yours very truly,

**McCarthy Tétrault LLP**

Per:

Richard J. Balfour

RB/gp

Encl

July 29, 2011

In the Matter of
the Securities Legislation of
British Columbia and Ontario
(the Jurisdictions)

and

In the Matter of
the Process for Exemptive Relief Applications in Multiple Jurisdictions

and

In the Matter of
Westcoast Energy Inc. and Union Gas Limited
(the Filers)

Decision

**Background**

¶1 The securities regulatory authority or regulator in each of the Jurisdictions (the Decision Maker) has received an application from Westcoast Energy Inc.

(Westcoast) and Union Gas Limited (Union Gas) for a decision under the securities legislation of the Jurisdictions (the Legislation) exempting each Filer from the requirements under section 3.2 of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards* (NI 52-107) that financial statements be prepared in accordance with Canadian GAAP applicable to publicly accountable enterprises (the Exemption Sought) to permit each Filer to prepare its financial statements in accordance with U.S. GAAP for its financial years that begin on or after January 1, 2012, but before January 1, 2015.

Under the Process for Exemptive Relief Applications in Multiple Jurisdictions (for a dual application):

(a) the British Columbia Securities Commission is the principal regulator of each Filer for this application;

(b) the Filers have provided notice that subsection 4.7(1) of Multilateral Instrument 11-102 *Passport System* (MI 11-102) is intended to be relied upon in Alberta, Saskatchewan, Manitoba, Québec, Nova Scotia, New Brunswick, Prince Edward Island and Newfoundland and Labrador (the Westcoast Passport Jurisdictions) with respect to Westcoast and in Alberta, Saskatchewan, Manitoba, Québec, Nova Scotia, New Brunswick, Prince Edward Island and Newfoundland and Labrador (the Union Gas Passport Jurisdictions) with respect to Union Gas; and

(c) this decision is the decision of the principal regulator and evidences the decision of the securities regulatory authority or regulator in Ontario.

**Interpretation**

¶2 Terms defined in National Instrument 14-101 *Definitions*, MI 11-102, National Instrument 51-102 *Continuous Disclosure Obligations* or NI 52-107 have the same meaning if used in this decision, unless otherwise defined herein.

**Representations**

¶3 This decision is based on the following facts represented by the Filers:

1. Westcoast is a corporation existing under the *Canada Business Corporations Act*. The head office of Westcoast is in Vancouver, British Columbia;

2. Union Gas is a corporation existing under the *Business Corporations Act* (Ontario). The head office of Union Gas is in Chatam, Ontario;

3. Union Gas has chosen the British Columbia Securities Commission as the principal regulator for this application on the basis that British Columbia is the

jurisdiction with which Union Gas has the next most significant connection, as Union Gas is a subsidiary of Westcoast and Westcoast's head office is located in British Columbia. The Ontario Securities Commission has granted its consent to Union Gas's request for a change in principal regulator with respect to this application under section 3.7(2) of National Policy 11-203 *Process for Exemptive Relief in Multiple Jurisdictions*;

4. Westcoast is a reporting issuer or equivalent in the Jurisdictions and each of the Westcoast Passport Jurisdictions; Union Gas is a reporting issuer or equivalent in the Jurisdictions and each of the Union Gas Passport Jurisdictions; Filer is in default of securities legislation in any jurisdiction;

5. the Filers are not SEC issuers;

6. the Filers each have "activities subject to rate regulation", as defined in the Handbook;

7. as a "qualifying entity" for the purposes of section 5.4 of NI 52-107, each Filer is permitted by that provision to prepare its financial statements for its financial year commencing January 1, 2011 and ending December 31, 2011 in accordance with Canadian GAAP – Part V of the Handbook; and

8. if each of the Filers were an SEC issuer, each would be permitted by section 3.7 of NI 52-107 to file its financial statements prepared in accordance with U.S. GAAP, which accords treatment of "activities subject to rate regulation" similar to that under Canadian GAAP – Part V.

**Decision**

¶4 Each of the Decision Makers is satisfied that the decision meets the test set out in the Legislation for the Decision Maker to make the decision.

The decision of the Decision Makers under the Legislation is that the Exemption Sought is granted provided that:

(a) for its financial years commencing on or after January 1, 2012 but before January 1, 2015 and interim periods therein, each Filer prepares its financial statements in accordance with U.S. GAAP; and

(b) information for comparative periods presented in the financial statements referred to in paragraph (a) is prepared in accordance with U.S. GAAP.

The Exemption Sought will terminate in respect of a Filer's financial statements for annual and interim periods commencing on or after the earlier of:

(a) January 1, 2015; and

(b) the date on which such Filer ceases to have "activities subject to rate regulation" as defined in the Handbook as at the date of this decision.

Martin Eady, CA
Director, Corporate Finance
British Columbia Securities Commission

# Transition to US GAAP – Employee Future Benefits

The following document describes Union Gas Limited's ("Union" or "the Company") transition to US GAAP for Employee Future Benefits (EFB).

## Background

In 2008, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) announced that publicly accountable enterprises are required to adopt International Financial Reporting Standards (IFRS) in place of Canadian Generally Accepted Accounting Principles (CGAAP) for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

In September 2010, the AcSB offered an optional one year deferral for adopting IFRS for qualifying entities with rate-regulated activities and permitted such entities to continue to apply the pre-changeover accounting standards of the CICA Handbook during that period. Union is a qualifying entity for purposes of this deferral and elected to defer the adoption of IFRS to review the option to report under United States Generally Accepted Accounting Principles (US GAAP).

IFRS currently does not adequately provide for accounting for rate-regulated activities. Adoption of IFRS by Union would create significant uncertainty in its financial reporting and have a substantial impact on its financial results at the time of adoption. The anticipated impact to Union of the adoption of IFRS is a substantial retained earnings loss and ongoing income statement volatility and uncertainty. IFRS would not transparently reflect the actual economic effects of rate regulation.

US GAAP provides a well-recognized, accepted and comprehensive basis of accounting for rate-regulated activities that is substantially similar to CGAAP and will provide Union with consistency that reflects the economic realities of these activities.

The adoption of US GAAP by Union would avoid the current uncertainty about the application of IFRS to rate-regulated activities, including uncertainty concerning the substantial one-time adjustments and implementation issues upon adoption and any possible future adjustments to IFRS to address rate-regulated activities.

In 2011, Canadian security regulators have approved Union's election to report under US GAAP instead of IFRS effective January 1, 2012. To be consistent with financial reporting, Union is proposing to adopt US GAAP for rate making.

Differences between CGAAP and US GAAP are far less than the differences that would have existed had Union adopted IFRS. The only impact to utility earnings of reporting under US GAAP is to the employee future benefits expense.

## Differences in Reporting Standards

The current standard for Canadian GAAP reporting is CICA 3461 and the equivalent standard for US GAAP reporting is ASC 715.

The following is a discussion regarding the significant differences impacting the Company on its transition to US GAAP.

### Financial Statement Recognition

| | |
|---|---|
| *Balance Sheet Assets – limits* | Under Canadian GAAP, there is a limit on the amount that can be recognized as an asset in excess of the expected future benefit; however, the Company does not currently have a valuation against its current asset.<br>Under US GAAP, there is no limit on the asset and the amount recognized as an asset is the surplus of the funded status. |
| *Balance Sheet Liability* | Under Canadian GAAP, a balance sheet liability reflects the cumulative amount expensed less the cumulative amount funded. The balance sheet does not include any unamortized actuarial losses, unamortized past service costs or the unamortized transitional obligation.<br>Under US GAAP, the balance sheet liability reflects an underfunding of the plan including the unamortized actuarial losses and unamortized past service costs. |
| *Balance Sheet – equity* | Under US GAAP, any amounts that have not yet been recognized in net periodic cost are reflected in Accumulated Other Comprehensive Income (AOCI) until they are recognized through net periodic cost. This concept does not exist in Canadian GAAP for EFB. |
| *Costs Recognized in Net Periodic Cost* | When Canadian GAAP transitioned to CICA 3461 on January 1, 2000, a transitional amount was recognized and amortized over the expected average remaining service life on the plan employees at that time. The transitional amount related to unamortized actuarial losses at the time of transition.<br>Under US GAAP, the transitional amount would have been fully amortized by January 1, 2012 as the transition to a similar standard to CICA 3461 in US GAAP occurred on January 1, 1989.<br>Because this amount will not be amortized in the future under US GAAP, net periodic cost for future years will be lower than under Canadian GAAP until 2017 at which time it would have been fully amortized under Canadian GAAP.<br>There are no other significant differences in other components of net periodic cost. |

*Negative Service Cost*

The Company has unrecognized negative prior service costs due to changing the post-retirement benefit plan from a primarily benefits based program to a program consisting of a Heath Care Spending Account, plus catastrophic coverage.

Under Canadian GAAP, these negative costs were used to reduce the unamortized transitional obligation that existed at the time of the plan amendment.

Under US GAAP, these amounts are being amortized over the expected average remaining service life. The amounts not yet recognized are recorded in AOCI.

**Measurement of the Benefit Obligation**

*Valuation*

Canadian GAAP allows for a measurement date of up to three months prior to the balance sheet date. The Company currently uses September 30th as its measurement date.

US GAAP does not allow for early measurement and as such, the Company will change its measurement date to December 31st.

The largest impact this change will have is on the calculation of the benefit obligation due to determining the discount rate at December 31st rather than September 30th. All other assumptions are management's best estimate and generally have not changed from the September 30th valuation for Canadian GAAP to the December 31st valuation date currently used for US GAAP.

**Disclosures**

Additional disclosures required by US GAAP include:

- Accumulated Benefit Obligation (ABO)
- Projected Benefit Obligation (PBO), ABO and fair value of plan assets with ABO > fair value of plan assets for plans with PBO > fair value of plan assets
- Asset investment strategy
- Balance sheet classification (current vs. noncurrent)
- Amounts recognized on balance sheet, including amounts recognized in AOCI and effects of additional minimum liability
- Changes in AOCI due to deferred costs/income arising during the year (i.e., gains/losses and prior service cost/credit) and amortizations during the year
- Employer contributions expected in next fiscal year
- Benefits expected to be paid (each of next five years & 5-year period thereafter)
- Basis for determining expected return on assets
- Estimated amortizations for coming year
- Prior service cost recognition policy

The Company currently discloses these items for reporting to its parent company.

## Net Periodic Cost Differences

The net periodic cost for US GAAP is different than Canadian GAAP due to two main differences:

- the measurement date is currently different between the two expense amounts. This effects all components of net periodic cost, and
- the transitional obligation is being expensed for Canadian GAAP purposes. This effects only the amortization of the transitional obligation of net periodic cost. For US GAAP purposes of net periodic cost in 2011 and beyond, this amortization does not exist.

## Entry upon Transition to US GAAP on January 1, 2012

At January 1, 2012, an entry will need to be made into SAP to bring the EFB balances to the appropriate balances for US GAAP reporting for Canadian purposes. The amounts cannot be determined until after the December 31, 2011 year end but the entry will be comprised of:

| | |
|---|---|
| DR AOCI | The debit to AOCI will be for the unrecognized amounts of actuarial gains/losses and prior service costs. These amounts will be recognized systematically through net periodic cost in future years. |
| CR EFB Liability | The credit to the EFB Liability account will be the difference between the Accrued Benefit Asset recorded at December 31, 2011 for Canadian GAAP reporting and the funded status of all the plans at December 31, 2011. This will eliminate the Pension Asset and increase the EFB Liability account to the funded status for US GAAP reporting. |
| DR Retained Earnings *(see below re: Regulatory Asset)* | The difference between the credit and debit above will be recognized through retained earnings as these costs would have been expensed in prior years under US GAAP. |

**Regulatory Asset**

Under Canadian GAAP, the amount to be charged to Retained Earnings (above) would have been expensed through the income statement until 2017. Therefore, the expense for the years until 2017 under US GAAP will be less than it would have been if the reporting standards had not changed.

Union recovers the pension expense through rates by what is charged to net periodic cost. If there are amounts charged to Retained Earnings, these will never flow through net periodic cost to be recovered from rate payers. Therefore, UGL will propose to the Ontario Energy Board (OEB) to set up a deferral account to recover these costs from rate payers for the amounts charged to Retained Earnings. This will result in the following entry:

| | |
|---|---|
| DR Regulatory Asset | The debit to a Regulatory Asset will be for the amount to be recovered through future rates. |
| CR Retained Earnings | The credit to Retained Earnings will be for the same amount that can be recovered through the deferral account. |

*(this entry may be netted with the entry above)*

**Amortization of Regulatory Asset**
If Canadian GAAP had continued, the amount that will be set up as a Regulatory Asset would have been amortized through expense until 2017.

Because the UGL is currently in an Incentive Regulation framework, the amortization for 2012 would have already been included in rates and therefore, that year's amortization will be expensed in 2012 to draw down the Regulatory Asset. The Regulatory Asset that remains at December 31, 2012 will be brought before the OEB for recovery in 2013. The Company will amortize into expense the Regulatory Asset on the timeline as approved by the OEB beginning in 2013.

**ADOPTION OF UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

In February 2008, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) confirmed that publicly accountable enterprises are required to adopt International Financial Reporting Standards (IFRS) in place of Canadian Generally Accepted Accounting Principles (CGAAP) for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

In September 2010, the AcSB offered an optional one year deferral to adopt IFRS for qualifying entities with rate regulated activities and permit such entities to continue to apply Part V – Pre changeover accounting standards of the CICA Handbook during that period. Union Gas is a qualifying entity for purposes of this deferral and elected to defer the adoption of IFRS while reviewing our option to report under United States Generally Accepted Accounting Principles (US GAAP).

In July 2011, Canadian security regulators have approved our election to report under US GAAP instead of IFRS effective January 1, 2012, until January 1, 2015.

For all periods up to and including the year ended December 31, 2011, we prepared our consolidated annual and interim financial statements in accordance with Part V – Pre changeover accounting standards of the CICA Handbook.

We have prepared our financial statements in compliance with US GAAP applicable for periods on or after January 1, 2012 as described in the accounting policies. The adoption of US GAAP has been made on a retrospective basis. The financial statements for prior periods have been restated in accordance with US GAAP in effect at that time. Our date of transition to US GAAP is January 1, 2012. This note explains the principal adjustments made by us in restating our Consolidated Balance Sheet as at January 1, 2011, the Interim Consolidated Balance Sheet as at March 31, 2011, the Interim Consolidated Statement of Income and Comprehensive Income and the Interim Consolidated Statement of Cash Flows for three months ended March 31, 2011.

The following reconciliations provide details of the impact of the transition to US GAAP on:

- Consolidated Balance Sheet at January 1, 2011
- Interim Consolidated Balance Sheet at March 31, 2011
- Interim Consolidated Statement of Income and Comprehensive Income for three months ended March 31, 2011
- Interim Consolidated Statement of Cash Flows for three months ended March 31, 2011

# Union Gas Limited
## Reconciliation of Interim Consolidated Statement of Income and Comprehensive Income
## For Three Months Ended March 31, 2011
## (in millions)

| | Previously Reported Under CGAAP | Income Taxes | Restated Under US GAAP |
|---|---|---|---|
| Gas sales and distribution revenue | 599 | – | 599 |
| Cost of gas | 365 | – | 365 |
| Gas distribution margin | 234 | – | 234 |
| Storage and transportation revenue | 83 | – | 83 |
| Other revenue | 5 | – | 5 |
| | 322 | – | 322 |
| Expenses | | | |
| Operating and maintenance | 91 | – | 91 |
| Depreciation and amortization | 52 | – | 52 |
| Property and capital taxes | 16 | – | 16 |
| | 159 | – | 159 |
| Income before other items | 163 | – | 163 |
| Interest expense | 38 | – | 38 |
| Income before income taxes | 125 | – | 125 |
| Income taxes | 28 | 1 | 29 |
| Net income and comprehensive income | 97 | (1) | 96 |
| Preference share dividends | 1 | – | 1 |
| Net income applicable to common shares | 96 | (1) | 95 |

# Union Gas Limited
# Reconciliation of Consolidated Balance Sheet
# As of January 1, 2011
# (in millions)

| | Previously Reported Under CGAAP | Deferred Financing Costs | Employee Future Benefits | Mandatorily Redeemable Preferred Shares | Income Taxes | Other | Total Adjustments | Restated Under US GAAP |
|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | |
| Current assets | | | | | | | | |
| Cash and cash equivalents | **12** | – | – | – | – | – | – | **12** |
| Accounts receivable | **516** | – | – | – | – | – | – | **516** |
| Income taxes receivable | **–** | – | – | – | 17 | – | 17 | **17** |
| Inventories | **174** | – | – | – | – | – | – | **174** |
| Future income taxes | **14** | – | – | – | – | – | – | **14** |
| Total current assets | **716** | – | – | – | 17 | – | 17 | **733** |
| Property, plant and equipment | | | | | | | | |
| Cost | **6,370** | – | – | – | – | – | – | **6,370** |
| Accumulated depreciation | **1,994** | – | – | – | – | – | – | **1,994** |
| Property, plant and equipment, net | **4,376** | – | – | – | – | – | – | **4,376** |
| Regulatory and other assets | **493** | 9 | (137) | – | – | (1) | (129) | **364** |
| **Total Assets** | **5,585** | 9 | (137) | – | 17 | (1) | (112) | **5,473** |
| **Liabilities and Equity** | | | | | | | | |
| Current liabilities | | | | | | | | |
| Short-term borrowings | **198** | – | – | – | – | – | – | **198** |
| Commercial paper | **157** | – | – | – | – | – | – | **157** |
| Accounts payable and accrued charges | **586** | – | – | – | 1 | (1) | – | **586** |
| Income taxes payable | **8** | – | – | – | (8) | – | (8) | **–** |
| Long-term debt | **250** | – | – | – | – | – | – | **250** |
| Total current liabilities | **1,199** | – | – | – | (7) | (1) | (8) | **1,191** |
| Long-term liabilities | | | | | | | | |
| Long-term debt | **1,978** | 9 | – | – | – | – | 9 | **1,987** |
| Mandatorily redeemable preference shares | **5** | – | – | (5) | – | – | (5) | **–** |
| Future income taxes | **361** | – | – | – | (63) | – | (63) | **298** |
| Asset retirement obligations | **123** | – | – | – | – | – | – | **123** |
| Regulatory and other liabilities | **468** | – | 115 | – | 24 | – | 139 | **607** |
| Total long-term liabilities | **2,935** | 9 | 115 | (5) | (39) | – | 80 | **3,015** |
| **Total Liabilities** | **4,134** | 9 | 115 | (5) | (46) | (1) | 72 | **4,206** |
| Equity | | | | | | | | |
| Share capital | **732** | – | – | 5 | – | – | 5 | **737** |
| Retained earnings | **710** | – | – | – | – | – | – | **710** |
| Accumulated other comprehensive loss | – | – | (252) | – | 63 | – | (189) | **(189)** |
| Non-controlling interest | **9** | – | – | – | – | – | – | **9** |
| **Total Equity** | **1,451** | – | (252) | 5 | 63 | – | (184) | **1,267** |
| **Total Liabilities and Equity** | **5,585** | 9 | (137) | – | 17 | (1) | (112) | **5,473** |

# Union Gas Limited
## Reconciliation of Interim Consolidated Balance Sheet
## As of March 31, 2011
## (in millions)

| | Previously Reported Under CGAAP | Opening Balance Adjustment | Cash Pooling | Pension Adjustment | Income Taxes | Other | Total Adjustments | Restated Under US GAAP |
|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | |
| Current assets | | | | | | | | |
| Cash and cash equivalents | **4** | – | 2 | – | – | – | 2 | **6** |
| Accounts receivable | **566** | – | – | – | – | – | – | **566** |
| Inventories | **45** | – | – | – | – | – | – | **45** |
| Future income taxes | **12** | – | – | – | – | – | – | **12** |
| Total current assets | **627** | – | 2 | – | – | – | 2 | **629** |
| Property, plant and equipment | | | | | | | | |
| Cost | **6,418** | – | – | – | – | – | – | **6,418** |
| Accumulated depreciation | **2,036** | – | – | – | – | – | – | **2,036** |
| Property, plant and equipment, net | **4,382** | – | – | – | – | – | – | **4,382** |
| Regulatory and other assets | **486** | (129) | – | (2) | – | – | (131) | **355** |
| **Total Assets** | **5,495** | (129) | 2 | (2) | – | – | (129) | **5,366** |
| | | | | | | | | |
| **Liabilities and Equity** | | | | | | | | |
| Current liabilities | | | | | | | | |
| Short-term borrowings | **100** | – | – | – | – | – | – | **100** |
| Commercial paper | **26** | – | – | – | – | – | – | **26** |
| Accounts payable and accrued charges | **605** | – | 2 | – | – | 1 | 3 | **608** |
| Income taxes payable | **30** | (25) | – | – | – | – | (25) | **5** |
| Long-term debt | **250** | – | – | – | – | – | – | **250** |
| Total current liabilities | **1,011** | (25) | 2 | – | – | 1 | (22) | **989** |
| Long-term liabilities | | | | | | | | |
| Long-term debt | **1,978** | 9 | – | – | – | – | 9 | **1,987** |
| Mandatorily redeemable preference shares | **5** | (5) | – | – | – | – | (5) | **–** |
| Future income taxes | **371** | (63) | – | – | 2 | (1) | (62) | **309** |
| Asset retirement obligations | **125** | – | – | – | – | – | – | **125** |
| Regulatory and other liabilities | **474** | 139 | – | (8) | – | 1 | 132 | **606** |
| Total long-term liabilities | **2,953** | 80 | – | (8) | 2 | – | 74 | **3,027** |
| **Total Liabilities** | **3,964** | 55 | 2 | (8) | 2 | 1 | 52 | **4,016** |
| | | | | | | | | |
| Equity | | | | | | | | |
| Share capital | **732** | 5 | – | – | – | – | 5 | **737** |
| Retained earnings | **790** | – | – | – | (1) | – | (1) | **789** |
| Accumulated other comprehensive loss | **–** | (189) | – | 6 | (1) | (1) | (185) | **(185)** |
| Non-controlling interest | **9** | – | – | – | – | – | – | **9** |
| **Total Equity** | **1,531** | (184) | – | 6 | (2) | (1) | (181) | **1,350** |
| **Total Liabilities and Equity** | **5,495** | (129) | 2 | (2) | – | – | (129) | **5,366** |

# Union Gas Limited
## Reconciliation of Interim Consolidated Statement of Cash Flows
## For the Three Months Ended March 31, 2011
## (in millions)

| | Previously Reported Under CGAAP | Cash Pooling | Income Taxes | Total Adjustments | Restated Under US GAAP |
|---|---|---|---|---|---|
| **Cash Flows from Operating Activities** | | | | | |
| Net income | **97** | – | (1) | (1) | **96** |
| Items not affecting cash | | | | | |
| Depreciation and amortization | **52** | – | – | – | **52** |
| Future income taxes (recovery) | **(2)** | – | 1 | 1 | **(1)** |
| Changes in working capital | **142** | 2 | – | 2 | **144** |
| | **289** | 2 | – | 2 | **291** |
| **Cash Flows from Investing Activities** | | | | | |
| Capital expenditures | **(51)** | – | – | – | **(51)** |
| **Cash Flows from Financing Activities** | | | | | |
| Net decrease in short-term borrowings | **(98)** | – | – | – | **(98)** |
| Net decrease in commercial paper | **(131)** | – | – | – | **(131)** |
| Dividends paid | **(17)** | – | – | – | **(17)** |
| | **(246)** | – | – | – | **(246)** |
| Change in cash and cash equivalents, during the period | **(8)** | 2 | – | 2 | **(6)** |
| Cash and cash equivalents, beginning of period | **12** | – | – | – | **12** |
| Cash and cash equivalents, end of period | **4** | 2 | – | 2 | **6** |
| **Supplementary Disclosure of Cash Flow Information** | | | | | |
| Cash payments of interest | **40** | | | | **40** |
| Cash payments of income taxes | **8** | | | | **8** |

**Notes to Transitional Adjustments from CGAAP to US GAAP**

**Deferred Financing Costs**
Under CGAAP, unamortized deferred financing costs are classified as long-term debt. Under US GAAP, the unamortized deferred financing costs are classified as a long-term deferred asset. Unamortized deferred financing costs of $9 million have been reclassified from Long-term debt to Other assets at transition to US GAAP.

**Employee Future Benefits**
Under CGAAP, the pension asset or liability represents the cumulative contribution to the plans netted with the cumulative benefit cost of the plans. Under US GAAP, the pension asset or liability is recorded at the present value of the defined benefit obligation less the fair value of plan assets. Unrecognized actuarial gains or losses and unrecognized prior service costs or credits are recorded to Accumulated other comprehensive income.

On transition to US GAAP, amounts not recorded to Accumulated other comprehensive income were established as Regulatory assets. This included the transitional obligation recorded under CGAAP on adoption of CICA Handbook section 3461 Employee Future Benefits and amounts resulting from changing the measurement date from September 30 under CGAAP to December 31 under US GAAP.

On transition to US GAAP, the adjustments made to comply with US GAAP resulted in a decrease of $137 million to Regulatory and other assets, an increase of $115 million to Regulatory and other liabilities and a loss of $252 million to Accumulated other comprehensive loss. For the three months ended March 31, 2011, the adjustments resulted in a decrease of $2 million to Regulatory and other assets, a decrease of $8 million to Regulatory and other liabilities and an income of $6 million to Accumulated other comprehensive loss.

**Mandatorily Redeemable Preferred Shares**
Under CGAAP, mandatorily redeemable preferred shares are classified as long-term debt. Under US GAAP, mandatorily redeemable preferred shares are classified as equity. On transition to US GAAP, $5 million of preferred shares that are mandatorily redeemable were reclassified from Long-term debt to Share capital.

**Income Taxes**
The change in future income taxes represents the tax effect of the US GAAP transition adjustments discussed above. US GAAP also requires certain tax reserves to be classified as current. On transition to US GAAP, this resulted in a decrease of $8 million to Income taxes payable, an increase of $17 million to Income taxes receivable, a decrease of $63 million to Future income taxes, an increase of $1 million to Accounts payable and accrued charges, a decrease of $63 million to Accumulated other comprehensive loss, and an increase of $24 million to Regulatory and other liabilities. For the three months ended March 31, 2011, the adjustments resulted in an increase of $2 million to Future income taxes, an increase of $1 million to Accumulated other comprehensive loss and a decrease of $1 million to Retained earnings.

**Cash Pooling**
Under CGAAP, cash accounts are netted against one another within Cash and cash equivalents. Under US GAAP, negative book balances are only offset against positive book balances if the legal right of offset exists within the same financial institution. These negative book balances that cannot be netted are classified as Accounts payable and accrued charges. On transition to US GAAP, no reclassification was required. For the three months ended March 31, 2011, $2 million in negative book balances were reclassified from Cash and cash equivalents to Accounts payable and accrued charges.

**Union Gas Limited**
**Employee Future Benefit Programs**
**Conversion from CICA 3461 to ASC 715 for Canadian Reporting**
**($millions)**

DRAFT

| | CICA 3461 | | | US GAAP transition | | | ASC 715 - Canadian Reporting | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Pension** | **Other** | **Total** | **Pension** | **Other** | **Total** | **Pension** | **Other** | **Total** |
| **As at January 1, 2011** | | | | | | | | | |
| Fair value of assets (end of period) | 503.0 | - | 503.0 | | | | 529.6 | - | 529.6 |
| Accrued benefit obligation (end of period) | 655.3 | 69.3 | 724.6 | | | | 637.3 | 68.4 | 705.7 |
| Funded status | (152.3) | (69.3) | (221.6) | 44.6 | 0.9 | 45.5 | (107.7) | (68.4) | (176.1) |
| Unamortized net actuarial loss (gain) | 258.0 | 17.7 | 275.7 | (34.5) | (0.3) | (34.8) | 223.5 | 17.4 | 240.9 |
| Unamortized past service costs | 12.1 | - | 12.1 | (0.9) | - | (0.9) | 11.2 | - | 11.2 |
| Unamortized net transitional obligation (asset) | 6.3 | 7.6 | 13.9 | (6.3) | (7.6) | (13.9) | - | - | - |
| Contributions made after measurement date | 9.6 | 0.6 | 10.2 | (9.6) | (0.6) | (10.2) | - | - | - |
| AOCI for US GAAP | 286.0 | 25.9 | 311.9 | (51.3) | (8.5) | (59.8) | 234.7 | 17.4 | 252.1 |
| Prepaid (Accrued) benefit | 133.7 | (43.4) | 90.3 | (6.7) | (7.6) | (14.3) | 127.0 | (51.0) | 76.0 |
| **2011 Net benefit costs** | | | | | | | | | |
| Current service cost | 12.2 | 2.1 | 14.3 | (0.4) | (0.1) | (0.5) | 11.8 | 2.0 | 13.8 |
| Interest cost | 32.6 | 3.5 | 36.1 | 0.4 | 0.1 | 0.5 | 33.0 | 3.6 | 36.6 |
| Expected return on plan assets | (34.2) | - | (34.2) | - | - | - | (34.2) | - | (34.2) |
| Amortization of actuarial loss | 21.2 | 0.6 | 21.8 | (0.5) | - | (0.5) | 20.7 | 0.6 | 21.3 |
| Amortization of prior service costs | 1.6 | - | 1.6 | (0.1) | - | (0.1) | 1.5 | - | 1.5 |
| Amortization of transitional obligation | 1.5 | 1.8 | 3.3 | (1.5) | (1.8) | (3.3) | - | - | - |
| Net periodic benefit cost | 34.9 | 8.0 | 42.9 | (2.1) | (1.8) | (3.9) | 32.8 | 6.2 | 39.0 |

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Ex. A / Tab 1 / Page 18

Preamble:

Union stated that it is transitioning its accounting and reporting standards to US GAAP beginning January 1, 2012. Union requested a deferral account in this rate application in relation to the pension impact of transitioning to US GAAP.

Transitioning to US GAAP requires full retrospective application of all applicable standards. In other words, the financial statements are prepared as if Union had always been applying US GAAP.

a) Please confirm that the financial statements as at and for the year ended December 31, 2012 will contain comparative figures for 2011 that are also in accordance with US GAAP.

b) Assuming the financial statements as at and for the year ended December 31, 2012 will contain comparative figures for 2011 that are also in accordance with US GAAP, the adjustment to retained earnings would be the opening retained earnings balance at January 1, 2011. Accordingly, please clarify the date at which the charge to retained earnings for which Union is requesting a deferral account is being calculated.

c) Union has limited its request for a deferral account for the transition to US GAAP to amounts relating to pensions. Given that Union is required to report to its parent company under US GAAP, please confirm that Union has completed its analysis of differences between Canadian GAAP and US GAAP and that no further differences resulting in adjustments to retained earnings were identified. Please provide the completed analysis.

d) Please clarify whether the pension referred to by Union in the rate application also includes the Other Post Employment Benefits (OPEB).

e) Please provide a summary of the nature of all accounting differences identified resulting from the transitioning to US GAAP and the resulting impacts on revenue requirement, if any, expected by Union. Please show where the impacts are occurring, the quantum of the impacts, and the reasons underpinning the changes.

f) Please provide a copy of the opening balance sheet at the transition date (January 1, 2011) prepared in accordance with US GAAP and a reconciliation by line item to the balance sheet as at the same date prepared in accordance with Canadian GAAP.

g) Please describe the nature and extent of involvement of the external auditors and/or other professional consultants with the transition to US GAAP. To the extent that written reports, communications or other documentation, either internal or external, discussing the transition to US GAAP exist, please provide copies of all such reports, communications or other documentation. If the external auditors have not completed audit procedures related to the opening balance sheet, please indicate the expected timeframe for the completion of such procedures.

---

**Response:**

a) Confirmed.

b) The retained earnings adjustment will be set up in the deferral account as at January 1, 2011. This balance will be amortized in 2011 and 2012 to adjust the expense of employee future benefits to the Canadian GAAP equivalent to align with the accounting methodology used for ratemaking in those periods.

c) Please see the response at Exhibit B1.5 a) v).

d) Yes, the pension referred to by Union in the rate application also includes other post employment benefits.

e) Please see the response at Exhibit B1.5 a) v).

f) Please see the response at Exhibit B1.5 a) v).

g) Please see the response at Exhibit B1. 5 a) v). Union's external auditors are expected to complete their review of the opening balance sheet in Q4 2011. Other professional consultants involved in the transition to US GAAP include Union's actuaries (Towers Watson), who provided the employee future benefit numbers and calculated the retained earnings adjustment, and the law firm of McCarthy Tetrault, who was involved in Union's application to the securities administrators for exemptive relief.

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Ex. A / Tab 1 / Page 18
Security Exchange Commission ("SEC") Letter – February 23, 1995 (Attached as Appendix A)

Preamble:

Conversion to US GAAP generally requires full retrospective application of all standards, reflecting the effective date of each individual standard and any related amendments. However, the SEC issued a letter dated February 23, 1995 permitting foreign issuers that cannot implement SFAS 87 as of the effective date specified in the standard due to unavailability of actuarial data to adopt the standard as of a later date.

a) Please confirm whether Union will adopt the guidance under US GAAP for pension and OPEB as of the effective dates of the relevant standards. If Union has elected a different effective date based on the letter issued by the SEC, please provide the reasons why Union believes the exemption is applicable and the effective date chosen.

b) Please provide the portion of the transitional assets/liabilities resulting from the retrospective application of US GAAP which remain unamortized at the date of transition.

c) Please confirm that the amount to be recorded in the deferral account requested represents the difference between the transitional amounts under Canadian GAAP and US GAAP as identified in b). If not, please provide the amount and the reasons why the amount is different.

---

**Response:**

a) Union adopted US GAAP for Employee Future Benefits effective January 1, 2000. This was the adoption date of CICA 3461 and is considered to be the earliest date at which reliable information is available.

b) The transition obligation at January 1, 2011 is fully amortized for US GAAP. The conversion to US GAAP assumes the amortization of the net transition obligations as at January 1, 2000 commenced on January 1, 1989 (the effective date of the US standard). As the net transition obligations are amortized over the employee's average remaining service lives (EARSL) and all of the EARSL's are less than 21 years, no transitional obligation remains.

c) Please see the response at Exhibit B1.5 a) v).

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Ex. A / Tab 1 / Page 18
Union – 2010 Audited Financial Statements

Preamble:

Paragraph 2 of Note 13 Employee Future Benefits of Union's 2010 Audited Financial Statements (AFSs) stated that "Accrued benefit obligations are determined using the projected benefit method pro-rated on services. The Company uses a measurement date of September 30."

Paragraph 4 of Note 13 Employee Future Benefits of Union's 2010 AFSs stated that "The transitional obligation associated with the change in accounting for Employee Future Benefits at January 1, 2000 is being amortized on a straight line basis over the expected average remaining service life (EARSL) of employees active at January 1, 2000. The average remaining service period of the active employees covered by the retirement plan is 10 years. The average remaining service period of the active employees eligible for post retirement benefits other than pensions is 18 years."

The following exhibit is reproduced from Union's 2010 Audited Financial Statements (prepared under Canadian GAAP) Note 13 Employee Future Benefits:

| | **Years Ended December 31** | | | |
|---|---|---|---|---|
| *($million)* | **Pension** | | **Other** | |
| | **2010** | 2009 | **2010** | 2009 |
| **Funded Status** | | | | |
| Net funded status | **(152)** | (142) | **(69)** | (60) |
| Unamortized net actuarial loss | **258** | 238 | **17** | 11 |
| Unamortized net past service costs | **12** | 7 | **-** | - |
| Unamortized transitional obligation | **6** | 7 | **8** | 9 |
| Contribution remitted after measurement | **10** | 11 | **-** | 1 |
| Accrued benefit asset (liability), end of year | **134** | 121 | **(44)** | (39) |

Union requested a deferral account in relation to transition to US GAAP for pension on the following basis:

On transition to US GAAP, a charge to retained earnings will result due to amounts that would have been previously recognized through pension expense had Union been reporting in US GAAP historically. The charge to retained earnings is made up of two components: a change in measurement date from September 30 to December 31, and a write off of unrecognized actuarial losses that was established upon the implementation of CICA 3461. At the time of transition to CICA 3461, unrecognized actuarial losses were established and amortized over the expected remaining service life of the plan employees at that time. These unrecognized actuarial losses would have been fully amortized under US GAAP.

a) Please provide a copy of Union's 2010 AFSs and a copy of Union's AFSs in which the unrecognized actuarial losses at the time of transition to CICA 3461 were established.

b) Has Union made accounting policy choices under US GAAP for Pension and OPEB that are different than the corresponding accounting policy choices under Canadian GAAP? If so, please list the accounting policy choices made under Canadian GAAP and accounting policy choices made under US GAAP for the identified areas (such as actuarial valuation method, recognition of actuarial gains/losses; expected return on plan assets, etc.).

c) Please quantify the amount to be charged to retained earnings which Union has requested in this rate application be recorded in the deferral account.

d) Please break down the amount in c) into the two components claimed by Union to be the causes as follows:

   i) An amount resulting from "a change in measurement date from September 30 to December 31";

   ii) An amount resulting from "a write off of unrecognized actuarial losses" that was established upon the implementation of CICA 3461.

e) For the component related to the differences of measurement dates to be charged into retained earnings and requested to be included in the deferral account, please explain the following:

   i) the fiscal year that Union changes its measurement date from September 30 to December 31 and the transition option chosen;

   ii) for each fiscal year in which a December 31 measurement date is used for US GAAP, indicate the type of actuarial report received.

f) For the component related to "a write off of unrecognized actuarial losses" upon the implementation of CICA 3461, please confirm whether this component corresponds to the unamortized transitional obligation in the exhibit reproduced above from Union's 2010 AFSs. If the component is related to the unamortized transitional obligation presented on Union's 2010 AFSs but the amounts are not exactly equal to the amounts as at Dec 31, 2010, please provide a breakdown of the amounts for pension and OPEB as of the dates that Union will include the amounts into the deferral account requested in this rate application and an explanation of the difference.

g) Please provide a continuity schedule for unrecognized actuarial losses arising from the implementation of CICA 3461 from the time it started to 2010 year end as follows:

| | Year started (for example, Year 2000) to the end of 2010 | | | |
|---|---|---|---|---|
| | Opening balance as at the Year started | Accumulated Amortization recorded from the Year started to 2010 | Adjustments, if any, from the Year started to 2010 | Closing balance, as at December 31, 2010 |
| Pension | | | | |
| OPEB | | | | |

Note: Union should ensure that the opening balance and closing balance in the continuity schedule agree with the balances presented in its AFSs of respective years.

h) Please confirm that the amortization portion of unrecognized actuarial losses upon transition to CICA 3461 was included in Union's rates in the past. If so, how much was included? As of December 31, 2010, how much of these unrecognized actuarial losses upon transition to CICA 3461 were not included in the rates and hence not recovered from the rate payers?

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**Response:**

a) Please see Attachments 1 and 2.

b) The only difference between the Canadian GAAP and US GAAP accounting policies is the measurement date which affects the discount rate used. All other assumptions and accounting policies are the same.

c) Please see the response at Exhibit B1. 5 a) v).

d) Please see the response at Exhibit B1.5 a) v).

e)

i. Union will change to a December 31 measurement date on conversion to US GAAP as of January 1, 2011. US GAAP does not provide for an early measurement date.
ii. No previous fiscal years used a measurement date of December 31.

f) Please see the response at Exhibit B1.5 a) v).

g)

| | Pension | | | |
|---|---|---|---|---|
| | Opening balance | Amortization recorded in the year | Adjustments | Closing balance |
| 2000 | 25.9 | 1.8 | - | 24.1 |
| 2001 | 24.1 | 1.8 | (0.3) | 22.0 |
| 2002 | 22.0 | 1.8 | - | 20.2 |
| 2003 | 20.2 | 1.8 | - | 18.4 |
| 2004 | 18.4 | 1.7 | - | 16.7 |
| 2005 | 16.7 | 1.8 | - | 14.9 |
| 2006 | 14.9 | 1.8 | - | 13.1 |
| 2007 | 13.1 | 1.8 | - | 11.3 |
| 2008 | 11.3 | 1.8 | - | 9.5 |
| 2009 | 9.5 | 1.7 | - | 7.8 |
| 2010 | 7.8 | 1.5 | - | 6.3 |

| | OPEB | | | |
|---|---|---|---|---|
| | Opening balance | Amortization recorded in the year | Adjustments | Closing balance |
| 2000 | 40.0 | 2.4 | - | 37.6 |
| 2001 | 37.6 | 2.4 | - | 35.2 |
| 2002 | 35.2 | 2.3 | - | 32.9 |
| 2003 | 32.9 | 2.3 | (10.6) | 20.0 |
| 2004 | 20.0 | 1.8 | - | 18.2 |
| 2005 | 18.2 | 1.8 | - | 16.4 |
| 2006 | 16.4 | 1.7 | - | 14.7 |
| 2007 | 14.7 | 1.8 | - | 12.9 |
| 2008 | 12.9 | 1.8 | - | 11.1 |
| 2009 | 11.1 | 1.7 | - | 9.4 |
| 2010 | 9.4 | 1.8 | - | 7.6 |

h) Confirmed. Upon conversion to CICA 3461 on January 1, 2000, Union had $65.9 million of unrecognized actuarial losses. The annual amortization of approximately $3.6 million is included in rates.

# ANNUAL REPORT 2010

uniongas
A Spectra Energy Company

**Julie Dill**
**President**

March 16, 2011

Dear Shareholder:

I am pleased to forward you a copy of the Union Gas Limited (Union Gas) 2010 annual report. It contains Union Gas' management's discussion and analysis, management responsibility for financial reporting, consolidated financial results, and corporate directory. I invite you to visit www.sedar.com for electronic versions of Union Gas' consolidated financial statements, management's discussion and analysis, and other filings throughout the year.

Julie Dill
President

This discussion and analysis of Union Gas Limited for the twelve months ended December 31, 2010, should be read in conjunction with the audited consolidated financial statements and accompanying notes. The terms ("we," "our", "us" and "Union Gas") as used in this report refer collectively to Union Gas Limited and its subsidiary unless the context suggests otherwise. These terms are used for convenience only and are not intended as a precise description of any separate legal entity within Union Gas. The results reported herein have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and are presented in millions of Canadian dollars except where noted. Additional information relating to us, including our most recent Annual Information Form, can be found at www.sedar.com.

## FORWARD LOOKING INFORMATION

This Management's Discussion and Analysis (MD&A) includes forward-looking statements. Forward-looking statements are based on management's beliefs and assumptions. These forward-looking statements are identified by terms and phrases such as: anticipate, believe, intend, estimate, expect, continue, should, could, may, plan, project, predict, will, potential, forecast, and similar expressions. Forward-looking statements involve risks and uncertainties that may cause actual results to be materially different from the results predicted. Factors that could cause actual results to differ materially from those indicated in any forward-looking statement include, but are not limited to:

- local, provincial and federal legislative and regulatory initiatives that affect cost and investment recovery, have an effect on rate structure, and affect the speed at and degree to which competition enters the natural gas industries;
- outcomes of litigation and regulatory investigations, proceedings or inquiries;
- weather and other natural phenomena, including the economic, operational and other effects of storms;
- the timing and extent of changes in commodity prices and interest rates;
- general economic conditions which can affect the long-term demand for natural gas and related services;
- potential effects arising from terrorist attacks and any consequential or other hostilities;
- changes in environmental, safety and other laws and regulations;
- the development of alternative energy resources;
- results of financing efforts, including the ability to obtain financing on favourable terms, which can be affected by various factors, including credit ratings and general economic conditions;
- increases in the cost of goods and services required to complete capital projects;
- declines in the market prices of equity and debt securities and resulting funding requirements for defined benefit pension plans;
- growth in opportunities, including the timing and success of efforts to develop pipeline, storage, and other infrastructure projects and the effects of competition;
- the performance of transmission, storage and distribution facilities;
- the extent of success in connecting natural gas supplies to transmission systems and in connecting to expanding gas markets;
- the effects of accounting pronouncements issued periodically by accounting standard-setting bodies;
- conditions of the capital markets during the periods covered by the forward-looking statements; and

- the ability to successfully complete merger, acquisition or divestiture plans; regulatory or other limitations imposed as a result of a merger, acquisition or divestiture; and the success of the business following a merger, acquisition or divestiture.

In light of these risks, uncertainties and assumptions, the events described in the forward-looking statements might not occur or might occur to a different extent or at a different time than we have described. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

## GENERAL

Union Gas is a major Canadian natural gas storage, transmission and distribution company based in Ontario with 100 years of experience and service to customers. The distribution business serves approximately 1.3 million residential, commercial and industrial customers in more than 400 communities across northern, southwestern and eastern Ontario. Union Gas' growing storage and transmission business offers premium storage and transportation services to customers at the Dawn Hub (Dawn). Dawn is the largest underground storage facility in Canada and one of the largest in North America. It offers customers an important link in the movement of natural gas from Western Canadian and U.S. supply basins to markets in central Canada and the northeast U.S.

Our distribution system consists of approximately 60,600 kilometres of main and service pipelines. Our underground natural gas storage facilities have a working capacity of approximately 155 billion cubic feet (Bcf) in 23 underground facilities located in depleted gas fields. The transmission system consists of approximately 5,000 kilometres of high-pressure pipeline and six mainline compressor stations.

Union Gas' common shares are held by Great Lakes Basin Energy L.P., a wholly-owned limited partnership of Westcoast Energy Inc. (Westcoast). Westcoast is a wholly-owned subsidiary of Spectra Energy Corp (Spectra Energy).

Spectra Energy is a Delaware corporation that is a public company in the United States (U.S.) and whose shares are listed on the New York Stock Exchange.

Our board of directors is comprised of at least one-third independent directors with the remainder consisting of officers of Union Gas, Westcoast or Spectra Energy and there is no audit committee of the board. The function of an audit committee is carried out at the level of Spectra Energy during the review of its consolidated financial statements.

## HIGHLIGHTS

| | For the Years Ended December 31 | | |
|---|---|---|---|
| *($millions except where noted)* | **2010** | 2009 | 2008 |
| **Income** | | | |
| Total operating revenues | **1,830** | 2,019 | 2,130 |
| Earnings applicable to common shares | **204** | 173 | 175 |
| **Dividends** | | | |
| Dividends on preference shares | **2** | 2 | 5 |
| Dividends on common shares | **190** | 165 | 115 |
| **Assets and long-term liabilities** | | | |
| Total assets | **5,585** | 5,446 | 4,856 |
| Total long-term liabilities | **2,939** | 2,874 | 2,505 |
| **Volumes of gas ($10^6m^3$)**[1] | | | |
| Distribution volumes | **13,314** | 12,849 | 13,844 |
| Transportation volumes | **25,577** | 22,668 | 25,181 |
| Total throughput | **38,891** | 35,517 | 39,025 |
| **Customers** *(thousands)* | **1,344** | 1,325 | 1,309 |
| **Heating degree days**[2] *(degree Celsius)* | | | |
| Actual | **3,796** | 4,130 | 4,161 |
| Normal[3] | **4,056** | 4,034 | 4,070 |

1 $10^6m^3$ equals millions of cubic meters. One cubic meter is equivalent to 35.31467 cubic feet.
2 A heating degree day is a measure of temperature that identifies the need for heating. A degree day occurs when the average temperature falls below 18 degrees Celsius. A temperature of zero degrees Celsius equals 18 heating degree days.
3 As per OEB approved methodology used in setting rates.

## RESULTS OF OPERATIONS

| ($millions) | For The Three Months Ended December 31 2010 | 2009 | Increase (Decrease) | For The Years Ended December 31 2010 | 2009 | Increase (Decrease) |
|---|---|---|---|---|---|---|
| Gas sales and distribution revenue | 441 | 458 | **(17)** | 1,493 | 1,684 | **(191)** |
| Cost of gas | 238 | 276 | **(38)** | 794 | 1,026 | **(232)** |
| Gas distribution margin | 203 | 182 | **21** | 699 | 658 | **41** |
| Storage and transportation revenue | 78 | 71 | **7** | 308 | 299 | **9** |
| Other revenue | 6 | 11 | **(5)** | 29 | 36 | **(7)** |
| | 287 | 264 | **23** | 1,036 | 993 | **43** |
| Expenses | 160 | 163 | **(3)** | 631 | 608 | **23** |
| Other (income) and expenses, net | - | 2 | **(2)** | - | 2 | **(2)** |
| Interest expense | 41 | 41 | - | 158 | 160 | **(2)** |
| Income taxes | 8 | 8 | - | 41 | 48 | **(7)** |
| *Net income* | 78 | 50 | **28** | 206 | 175 | **31** |
| *Preference share dividends* | - | - | - | 2 | 2 | - |
| *Net income applicable to common shares* | 78 | 50 | **28** | 204 | 173 | **31** |

*Three month period ended December 31, 2010 compared to three month period ended December 31, 2009*

*Gas sales and distribution revenue.* The $17 million decrease was mainly driven by:

- a $35 million decrease from lower natural gas prices[4] passed through to customers without a mark-up, and
- a $7 million decrease due to higher earnings to be shared with customers, partially offset by
- a $25 million increase in customer usage of natural gas due to colder weather.

*Cost of gas*. The $38 million decrease was mainly driven by:

- a $35 million decrease from lower natural gas prices passed through to customers without a mark-up, and
- a $15 million decrease in operating fuel costs, partially offset by
- a $23 million increase due to higher volumes of natural gas sold due to colder weather.

*Storage and transportation revenue.* The $7 million increase in storage and transportation revenues was attributable to an increase in long term storage and long term transportation services provided to customers. These increases were partially offset by a decrease in short term storage services provided to customers.

*Twelve month period ended December 31, 2010 compared to twelve month period ended December 31, 2009*

*Gas sales and distribution revenue.* The $191 million decrease was mainly driven by:

- a $182 million decrease from lower natural gas prices passed through to customers without a mark-up, and
- a $23 million decrease in customer usage of natural gas due to weather that was more than 8% warmer than in 2009, partially offset by

[4] Natural gas prices passed through to customers without a mark-up are based on the 12 month New York Mercantile Exchange forecast.

- an $11 million increase due to a 2009 charge for a settlement on 2008 earnings to be shared with customers, and
- a $6 million increase due to growth in the number of customers.

*Cost of gas*. The $232 million decrease was mainly driven by:

- a $182 million decrease from lower natural gas prices passed through to customers without a mark-up,
- a $31 million decrease in operating fuel costs, and
- a $7 million decrease due to lower volumes of natural gas sold as a result of weather that was more than 8% warmer than in 2009.

*Storage and transportation revenue.* The $9 million increase in storage and transportation revenues was attributable to an increase in transportation services provided to customers and an increase in long-term storage resulting from a lower 2010 approved ratio of earnings to be shared with customers.

*Expenses.* The $23 million increase was the result of higher employee costs primarily related to pension costs that are associated with higher amortization of pension plan asset market value losses that have occurred in recent years.

*Income taxes.* The $7 million decrease was primarily due to a lower effective tax rate partially offset by higher pre-tax income.

## QUARTERLY RESULTS

| *($millions)* | Q1 2009 | Q2 2009 | Q3 2009 | Q4 2009 | Q1 2010 | Q2 2010 | Q3 2010 | Q4 2010 |
|---|---|---|---|---|---|---|---|---|
| Gas sales and distribution revenue | 788 | 254 | 184 | 458 | 608 | 258 | 186 | 441 |
| Storage and transportation revenue | 83 | 72 | 73 | 71 | 81 | 74 | 75 | 78 |
| Other revenue | 6 | 9 | 10 | 11 | 6 | 8 | 9 | 6 |
| Total operating revenues | 877 | 335 | 267 | 540 | 695 | 340 | 270 | 525 |
| Net income | 108 | 6 | 11 | 50 | 85 | 28 | 15 | 78 |
| Net income applicable to common shares | 107 | 6 | 10 | 50 | 84 | 28 | 14 | 78 |

### *Seasonal Trends*

The natural gas distribution business is highly seasonal due to volume-based rates and the significant effect of the winter heating season on volumes. This is typically reflected in strong first quarter results, second and third quarters that show either small profits or losses and strong fourth quarter results, subject to the impact of weather variations relative to demand during the winter heating season. Changes in natural gas rates that are charged to customers result in corresponding changes in gas sales and distribution revenue. These increases or decreases in gas sales revenue are completely offset in the cost of gas, as a result of the associated regulatory recovery and refund mechanisms.

## RATE REGULATION

Union Gas is regulated by the Ontario Energy Board (OEB) pursuant to the provisions of the Ontario Energy Board Act (1998), which is part of a package of legislation known as *The Energy Competition Act* (1998). This legislation provides for different forms of regulation and competition in the energy (electricity and natural gas) industry in Ontario. We are subject to regulation with respect to the rates that we may charge our customers, system expansion or facility abandonment, adequacy of service, public safety aspects of pipeline system construction and certain accounting practices.

In 2006, the OEB determined that it will forbear from regulating the prices for long-term storage services. The Storage Forbearance Decision created an unregulated storage operation within Union Gas and provides the framework required to support new storage investments. The decision requires Union Gas to continue to share long-term storage margins with ratepayers over a four-year phase-out period that started in 2008. Effective in 2011, there will no longer be any sharing of margins with Union Gas customers on long-term storage transactions.

*Incentive Regulation*

Our distribution rates, effective January 1, 2008 are set under a multi-year incentive regulation framework. The incentive regulation framework establishes new rates at the beginning of each year through the use of a pricing formula rather than through the examination of revenue and cost forecasts. The incentive regulation framework allows for annual inflationary rate increases, offset by a productivity factor of 1.82% that is fixed for each of the next five years. The framework also allows for rate increases in the small volume customer classes where average use is declining, a five-year term, certain adjustments to base rates, the continued pass-through of gas commodity, upstream transportation and demand side management costs, an allowance for unexpected cost changes that are outside of management's control, earnings sharing between Union Gas and our ratepayers beyond specified earnings levels and equal sharing of income tax changes between Union Gas and ratepayers.

The incentive regulation framework included a provision for a review of that framework if we experienced a variance of 3% or more between our actual utility return on equity (ROE) as normalized for weather and the benchmark utility ROE determined by the OEB. Our weather-normalized utility ROE for 2008 exceeded the upper review threshold, and accordingly, we filed for a review by the OEB in April 2009.

In June 2009, we recorded an $11 million charge as a result of a settlement approved by the OEB that amended the incentive regulation framework effective for 2008 by requiring us to share 90% of any utility ROE of 300 basis points or more above the benchmark utility ROE for the year with our customers. The $11 million charge represents the adjustment to credit to customers with 90% of our 2008 utility earnings that exceeded the 2008 benchmark utility ROE by 300 points.

In late 2010, the OEB approved Union Gas' 2011 regulated distribution, storage and transmission rates as determined pursuant to the incentive regulation framework. Changes to Union Gas' revenues are not expected to be material as a result of the new rates.

*Non-Commodity Deferral Account Disposition*

In April 2010, we applied for the annual disposition of the 2009 non-commodity deferral account balances. The combined impact on customers, including the impact of incentive regulation earnings sharing for 2009, is a credit of approximately $15 million. A settlement was reached with intervenors in July 2010, and approved by the OEB in August for changes to rates as of October 1, 2010.

*Commodity Rates*

Union Gas and the OEB have a mechanism in place to change gas commodity rates on a quarterly basis (Quarterly Rate Adjustment Mechanism), to ensure that customers' rates reflect future expected prices to the extent reasonably possible. The difference between the approved and the actual cost of gas incurred is deferred for future recovery from or repayment to customers. These differences are included in quarterly gas commodity rates and recovered from or refunded to customers over the subsequent twelve months and are also subject to review and approval by the OEB on an annual basis. This allows us to adjust customer rates closer to the time of incurrence.

*Cost of Capital*

In December 2009, the OEB issued its policy report on the Cost of Capital for Ontario's Regulated Utilities. In that report, the OEB determined that Union Gas' utility return on equity should be increased by approximately 125 basis points. The OEB also determined that it would only apply the conclusions from its policy report during cost-of-service applications. Accordingly, as we are currently under a five-year incentive regulation framework, we will incorporate the OEB's policy report determinations in our cost-of-service application for 2013 rates. That application is expected to be made by the end of 2011.

*Sale of the St. Clair Line*

In December 2008, we filed an application with the OEB to sell our St. Clair Line to the Dawn Gateway Pipeline Limited Partnership (DGP). The St. Clair Line runs approximately 12 kilometres in the Township of St. Clair located in southwestern Ontario, and was constructed in 1988 to bring new and additional gas supplies to Dawn. The need for the St. Clair Line was largely replaced by the construction of the Vector Pipeline in 2005, such that the St. Clair Line is underutilized.

Spectra Energy and DTE Pipeline Company, through various affiliates, have formed a 50:50 joint venture that proposes to offer a point-to-point transportation service from the Belle River Mills storage facility in Michigan to Dawn. As part of this joint venture, DGP was formed to own and operate the St. Clair Line and a new 17 kilometre section of pipeline to be constructed from the eastern end of the St. Clair Line to Dawn to support this new transportation service. In November 2009, the OEB approved the sale of the St. Clair Line from Union Gas to DGP, with such approval expiring on December 31, 2013. The OEB also determined that the sale price for ratemaking purposes should be set at a value higher than net book value as proposed by Union Gas and that ratepayers should receive a credit for the cumulative under-recovery in rates of the St. Clair Line from 2003 to the date of sale. A decision on the amount of the ratepayer credit was issued by the OEB in March 2010, establishing the amount of the credit as $6.4 million. The OEB also directed Union Gas to record the effect of removing the assets, revenues and costs of the St. Clair Line from regulated operations in a deferral account. In March 2010, the OEB approved DGP's proposal to construct a new 17 kilometre section of pipeline from the eastern end of the St. Clair Line to Dawn and a new light-handed regulatory framework for the Ontario-based portion of the new transportation service offered by DGP.

Since the OEB approved the proposed sale of our St. Clair Line to DGP in March 2010, rapidly changing market conditions have resulted in DGP and its shippers agreeing to delay construction of the Dawn Gateway Pipeline until November 2011 or November 2012, depending on market conditions. As a result of the delay, the sale of the St. Clair Line to DGP was not completed and the deferral accounts associated with the sale of the St. Clair Line have not been disposed of at this time. In February 2011, we filed evidence with the OEB requesting a further delay of the disposition of the deferral accounts. A hearing date to address this evidence has been set for April 6, 2011. DGP shippers have agreed to a final assessment of the viability of the Dawn Gateway Pipeline by November 2011, for possible service in 2012. If the shippers do not support the project at that time, the Dawn Gateway Pipeline project including the sale of the St. Clair Line will be cancelled.

## LIQUIDITY AND CAPITAL RESOURCES

We manage cash to maximize value while assuring appropriate amounts of cash are available, as required. We invest our available cash in high-quality money market securities. Such money market securities are designed for the safety of principal and for liquidity, and accordingly do not include equity-based securities.

We meet our short-term cash requirements through funds generated from operations, the utilization of loans from Westcoast, and the issuance of commercial paper. Long-term capital requirements for expansion, maintenance and investments are met through the combination of cash flow from operations, issuance of long-term debt and preference shares.

*Changes in Cash Flow*

| | For The Years Ended December 31 | |
|---|---|---|
| *($millions)* | **2010** | 2009 |
| Operating activities | **174** | 642 |
| Investing activities | **(232)** | (247) |
| Financing activities | **36** | (361) |

*Operating Activities*

Union Gas' heating season extends from approximately November through March. We begin the heating season with near-capacity natural gas inventory levels which are drawn throughout the heating season. Inventory levels decrease from December and thus contribute to a positive cash flow from operations during the first quarter. After the heating season ends, inventory is replenished for the next heating season. During the third quarter, gas inventory injections typically exceed withdrawals, negatively affecting cash flows. During the fourth quarter inventory decreases as withdrawals exceed injections.

Some of our customers purchase gas directly from marketers. Marketers typically deliver gas to us evenly throughout the year, whereas most of their customers use gas based on seasonality. As part of our normal billing process, we bill the marketers' customers as gas is used and remit this cash to the marketer when gas is delivered to us. Therefore, during the first and fourth quarters of the year, customers typically use more gas than is delivered to us and we collect cash from the marketers' customers creating a positive cash flow. During the second and third quarters, marketers deliver more gas than their customers use, thus creating a significant cash outflow. These are normal seasonal trends.

The primary factors impacting cash flow from operations for 2010 compared to 2009 include lower collections due to a lower spread between commodity rates charged to customers and actual gas costs, higher refunds to customers of over collection of commodity costs in 2009, and a large final payment of 2009 taxes made in the first quarter of 2010.

*Investing Activities*

The table below is a summary of capital expenditures:

| | For The Years Ended December 31 | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | *(estimated)* | | |
| Storage and transmission projects | 36% | 25% | 32% |
| Distribution | 50% | 59% | 57% |
| General equipment | 14% | 16% | 11% |
| | 100% | 100% | 100% |
| Total capital expenditure ($millions) | $305 | $232 | $247 |

The table below is a summary of capital project type:

| | For The Years Ended December 31 | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | *(estimated)* | | |
| Maintenance projects[5] | 92% | 97% | 92% |
| Expansion projects | 8% | 3% | 8% |
| | 100% | 100% | 100% |

Capital expenditures for 2010 were lower compared to 2009 due primarily to expansion and maintenance projects that were not completed in 2010 as planned or were deferred to 2011. Maintenance and expansion expenditures for 2011 are expected to be higher than the 2010 level of spending. The 2011 expansion capital expenditures reflect our continued assessment of the timing of projected long-term market requirements and general economic conditions. Based on our current assessment, we believe that expansion opportunities will continue to exist in the future.

As outlined in the financing activities discussion that follows, we have sufficient financing available to meet our investing requirements. Management expects that financing of 2011 projects will be done through a combination of cash generated from operations and available debt facilities.

*Financing Activities*

We have the following financing arrangements in place:

- In September 2010, Union Gas renewed its shelf prospectus. The shelf prospectus permits the issuance of medium-term notes, in one or more series, up to an aggregate principal amount of $500 million and for terms as covered in the pricing supplement at the time of issue with maturities of not less than one year from the date of issue. The shelf will expire in October 2012. As of December 31, 2010, $500 million was available.
    - In June 2010, we retired, at par, $185 million of Series 2 medium-term note debenture at 7.20% per annum.
    - In July 2010, under our previous shelf prospectus, we issued $250 million of medium-term note debentures at 5.20% per annum, due July 23, 2040.
    - In October 2010, we retired, at par, $37 million of 1988 Series 2 sinking fund debentures at 7.20% per annum.
- Union Gas has a $500 million committed credit facility available to help meet its short-term financing needs. As of December 31, 2010, $343 million was available.
    - Our $500 million committed credit facility expires in July 2012 and includes a provision which requires us to repay all borrowings under the facility for a period of two days during the second quarter of each year. This facility is intended to be used primarily to manage the significant changes in working capital experienced by Union Gas as a result of volumes and prices associated with natural gas purchases and sales. Most of the short-term cash requirements are funded through issuing commercial paper at rates generally below the lender's prime rate. Our 2010 commercial paper peaked in June at approximately $232 million.
- In July 2010, Union Gas cancelled the $15 million credit facility and the $1 million remaining letters of credit issued under the facility were moved to a credit facility of our parent, Spectra Energy Corp.

[5] Maintenance projects include costs incurred for new customer attachments. Maintenance projects also include expansion capital for in-franchise customers.

In order to maintain the common equity component of the capital structure at a level no greater than that approved by the OEB, we typically pay a quarterly dividend to our parent company. During 2010, we paid a quarterly dividend to our parent of approximately $16 million (2009 – approximately $16 million in first three quarters). In December 2010, we paid an additional $125 million dividend to our parent (2009 – $116 million paid in first quarter of 2010).

### OUTSTANDING SHARES

| | **December 31 2010** | December 31 2009 |
|---|---|---|
| **Redeemable Preference Shares** | | |
| Class A, Series A, 5.5% | **47,672** | 47,672 |
| Class A, Series C, 5.0% | **49,500** | 49,500 |
| | | |
| **Preference Shares** | | |
| Class A, Series B, 6.0% | **90,000** | 90,000 |
| Class B, Series 10, 4.88% | **4,000,000** | 4,000,000 |
| | | |
| **Common Shares** | **57,822,650** | 57,822,650 |

### FINANCIAL CONDITION

**Ratings Summary**

| | **Standard & Poor's** | **DBRS** |
|---|---|---|
| Commercial paper | A – 1 (low)[6] | R – 1 (low) |
| Debentures | BBB+ | A |
| Preference shares | P – 2 (low)[7] | Pfd – 2 |

Our credit ratings remain unchanged from those reported in the 2009 Annual Report.

The above credit ratings are dependent upon, among other factors, the ability to generate sufficient cash to fund capital and investment expenditures, our results of operations, market conditions and other factors. Our credit ratings could impact our ability to raise capital in the future, impact the cost of our capital and, as a result, have an impact on our liquidity.

[6] Represents Canadian National Scale Commercial Paper Rating.
[7] Represents Canadian Preferred Stock Rating.

## CONTRACTUAL OBLIGATIONS

The table below is a summary of our contractual payment obligations, due by period.

| *($millions)* | **Total** | **2011** | **2012-2013** | **2014-2015** | **Thereafter** |
|---|---|---|---|---|---|
| Long-term debt | 2,240 | 250 | – | 300 | 1,690 |
| Redeemable preference shares | 5 | – | – | – | 5 |
| Operating leases | 26 | 5 | 10 | 10 | 1 |
| Purchase obligations[8] | 1,038 | 510 | 209 | 192 | 127 |
| Environmental obligations[9] | 95 | 39 | 45 | 5 | 6 |
| Contributions to employee future benefit plan[10] | 46 | 46 | – | – | – |
| Total contractual obligations[11] | 3,450 | 850 | 264 | 507 | 1,829 |

## RELATED PARTY TRANSACTIONS

We purchase gas, storage and transportation services at prevailing market prices and under normal trade terms from related parties. During the year ended December 31, 2010, these purchases totalled $11 million (2009 – $6 million). Union Gas also provides storage and transportation services to related parties which totalled $1 million during 2010 (2009 – $1 million).

We provided administrative, management and other services to related parties totalling $10 million (2009 – $9 million), which were billed and recovered at cost. Charges from related parties for administrative and other goods and services were $9 million (2009 – $7 million).

At December 31, 2010 we have receivable balances of $2 million (2009 – $6 million) and payable balances of $3 million (2009 – $6 million) with related parties, all of which are recorded in accounts receivable and accounts payable, respectively.

During 2010, we obtained from and provided unsecured loans to Westcoast. The balance outstanding on these loans at December 31, 2010 was a $198 million payable (2009 – $6 million receivable). These loans are classified as short-term borrowings in 2010. Interest received on these loans during 2010 totalled less than $1 million (2009 – less than $1 million) and interest paid on these loans totalled less than $1 million (2009 – less than $1 million). Interest on these loans is calculated based on the monthly average of 30-day banker's acceptance rates.

8 Includes: firm capacity payments that provide us with uninterrupted firm access to natural gas transportation and storage; contractual obligations to purchase physical quantities of natural gas; contracts for software and consulting or advisory services; contractual obligations for engineering, procurement and construction costs for pipeline projects.

9 Includes capital, operating and maintenance expenditures related to the comprehensive certificate of approval.

10 We are unable to reasonably estimate employee future benefit plan contributions beyond 2011 due primarily to uncertainties about market performance of plan assets.

11 Excludes cash obligations for asset retirement activities. The amount of cash flows to be paid to settle the asset retirement obligations is not known with certainty as Union Gas may use internal resources or external resources to perform retirement activities. Amounts also exclude reserves for litigation, environmental remediation, annual insurance premiums that are necessary to operate the business and regulatory liabilities because Union Gas is uncertain as to the amount and/or timing of when cash payments will be required. Also, amounts exclude future income taxes and investment tax credits on the Consolidated Balance Sheets since cash payments for income taxes are determined based primarily on taxable income for each discrete fiscal year.

## GAS SUPPLY

The gas supply portfolio of Union Gas primarily includes contracts with pricing mechanisms that reflect monthly and daily variations in the price of gas. These contracts are indexed to either the New York Mercantile Exchange natural gas futures contracts, the Canadian Gas Price Reporter that publishes Alberta index prices or the Platt's Inside FERC Dawn Monthly Index.

Union Gas continues to monitor and evaluate the new and changing natural gas supply dynamics to determine what opportunities exist for Union Gas' customers. Union Gas has contracted for upstream transportation capacity to move new supplies to Ontario, including new supply sources based in the U.S. Rocky Mountains and U.S. southern shale supply areas. These new supplies began arriving in the Union Gas system on November 1, 2010. Union Gas has also taken steps to allow for the emerging Marcellus Shale gas supplies to serve its Ontario system customers beginning in 2012, including contracting for firm transportation capacity on other pipelines to facilitate moving this supply to Dawn and ultimately to our customers.

## OUTLOOK

### *Gas Sales and Distribution*

The significant increase in North American gas supply production coupled with moderate demand caused by the effects of the recent economic recession, resulted in low natural gas prices and low volatility in 2010. This trend is expected to continue in 2011. Despite low natural gas prices, the growth in demand for natural gas in our residential, commercial and industrial markets is expected to remain flat, however demand growth is expected from natural gas fired power generation.

Union Gas is experiencing a reduction in distribution throughput as a result of energy conservation due to our Demand Side Management (DSM) initiatives, declining normalized use per customer and a general trend toward warmer weather. We expect these trends to continue. In addition, the Ontario Ministry of Energy is continuing their commitment to aggressively promote a culture of conservation across the province that is expected to further reduce energy consumption, with corresponding impacts on our volume-based revenue.

Union Gas continues to support focused efforts to promote conservation and energy efficiency through our DSM programs. In each of 2009 and 2010, we spent $22 million promoting these programs with an increase in spending planned in 2011. In view of the significant efforts to build a culture of conservation in Ontario, we expect customers to continue to focus on reducing gas consumption by increasing investments in energy efficiency and conservation.

In May 2009, the Ontario Legislature passed the *Ontario Green Energy and Green Economy Act*, an Act to help transform the Ontario energy sector towards a culture of conservation and to encourage the development of renewable energy throughout the province. We will continue to monitor the legislation and we do not anticipate any material impact at this time.

### *Storage and Transportation*

The storage and transportation marketplace continues to deal with the global economic slowdown but is expected to be stable going forward. Weak commodity prices as a result of a more robust North American gas supply balance and narrower seasonal price spreads in the marketplace are expected to result in lower unregulated storage values. North American natural gas supplies continue to increase as result of new supply attachment including liquefied natural gas (LNG) and development in the U.S. Rocky Mountains, as well as various new shale gas resource projects such as the Barnett, Fayetteville, Woodford and the Marcellus Shale areas. The development of these new resources has increased overall North American gas supply reserves and is leading to significant new pipeline and storage infrastructure to connect these new supplies to the North American pipeline grid and the associated natural gas consuming market areas. These new supply sources will be available to serve Ontario and Eastern Canadian markets. Furthermore, we are experiencing a change in traditional natural gas flow patterns as these new supplies continue to develop. This will continue to provide Union Gas opportunities and challenges for new storage and pipeline infrastructure projects. Union Gas applied to the OEB, during 2010, for multiple transportation service enhancements to respond to these changing flow patterns. These services were approved by the OEB and will enhance access to emerging supply basins and provide enhanced flexibility to attract gas to Dawn, where it can be stored and delivered to downstream eastern markets.

The location of our storage and transportation facilities, with interconnections between major U.S. markets in the Great Lakes region and the U.S. Northeast continues to support long-term growth opportunities for us. It is our expectation that demand for natural gas in North America will continue to grow at a long-term rate of one percent per year along with continued growth in peak day demands.

*Storage Project Developments*

During 2010, Union Gas completed the drilling of additional storage wells in the Tipperary North and South storage reservoirs. These new wells were operational in 2010.

In June 2010, Union Gas purchased a depleted gas reservoir in the Municipality of Chatham-Kent from Torque Energy Inc. and Liberty Oil & Gas Ltd. A test well was completed in the reservoir in the fall of 2010 with favourable results. Senior Management approval to proceed with the project was provided in October 2010 with the application for OEB approval of the project filed in January 2011.

*Environmental, Health and Safety*

During 2008, we obtained approval from the Ontario Ministry of the Environment (MOE) for a multi-site comprehensive certificate of approval (CC of A) for the permitting of our air and noise emission sources. The CC of A will treat Union Gas as a single integrated natural gas storage, transmission and distribution system incorporating all storage pools, metering and regulating stations, compressor stations and buildings into a single environmental permit. The terms and conditions of the CC of A include significant financial obligations for capital, operating and maintenance expenditures over a period of approximately 10 years, and the total estimated obligation has been included in the Contractual Obligations section of this document. Under the terms of the CC of A, we will be allowed to add and modify facilities without prior approval from the MOE, thereby reducing the risk of delays associated with obtaining environmental permits. Union Gas remains on target to meet the current 10 year plan.

In 2010, the MOE confirmed Union Gas's third party audit plan. The purpose of the audits is to confirm that our facilities are operating in accordance with the conditions specified in the CC of A. In November 2010, the Parkway and Dawn compressor station sites were audited with no major findings. Furthermore, the MOE has also confirmed the 2011 audit schedule which will include the Hagar LNG Plant and the Waubuno and Bickford/Sombra Storage Pool Sites.

Union Gas has been notified that a Workwell audit will be conducted in the second quarter of 2011. Workwell is a health and safety management audit conducted by the Workplace Safety and Insurance Board. The Workwell audit is occurring as a result of an employee vehicle fatality in late 2009. We do not anticipate any material impact at this time.

*Global Climate Change*

Policymakers at provincial, federal and international levels continue to evaluate potential legislative and regulatory compliance mechanisms to achieve reductions in global greenhouse gas (GHG) emissions in an effort to address the challenge of climate change. It is likely that our assets and operations are or will become subject to direct and indirect effects of current and possible future global climate change regulatory actions in the jurisdictions in which those assets and operations are located. See Risk Factors – Global Climate Change Risk for further discussion.

## RISK FACTORS

Our earnings are affected by the risks inherent in the natural gas industry and energy marketplace. In general, our business and earnings level may be adversely affected by a number of risks as described below.

*Market Risk*

Sales to industrial customers are affected by general economic conditions, the absolute and relative price of alternative energy sources, foreign exchange rates and global competition. In 2011, we expect that the North American economy will continue to remain sluggish.

Sales to Union Gas' residential, small commercial and small industrial customers are affected by the number of new customer additions to the system, the price of natural gas, the warming trend in weather that is not fully reflected in rates, and the continued shift to higher efficiency. New customer additions increased slightly in 2010, but are expected to remain moderate in 2011. In 2011, the ongoing trend towards energy efficiency will continue to put pressure on usage.

A large quantity of our transportation capacity is now subject to renewal on an annual basis. Our standard contract terms provide automatic renewal of contracts, after the initial term, for one year at a time unless the customer provides two years prior notice of termination. For storage contracts, our standard contract terms do not allow for renewals but will typically have contract terms of one to five years. Due to changing gas supply patterns and as expected, one of our customers gave us notice in 2009 for transportation turnback starting in late 2011, and gave us notice in 2010 for additional turnback commencing in late 2012. This turnback was for capacity on our system that ultimately supplied the U.S. northeast by way of the customer's third party pipeline. This turned back capacity will be used to help satisfy increased demands to move gas from Dawn to points further east and north in Ontario and Quebec.

*Commodity Price Risk*

Fluctuations in natural gas prices affect our gas purchase costs for our own operating requirements as well as for the gas supply costs we incur for and collect from our system customers. Our gas procurement policy primarily includes contracts with pricing mechanisms that reflect monthly and daily variations in the price of gas. Commodity price volatility and absolute price levels also impact the amount of natural gas used by customers.

*Credit Risk*

Credit risk represents the loss that we could incur if a counterparty fails to perform under its contractual obligations. We analyze the customer's financial condition prior to entering into an agreement, obtain collateral when appropriate, establish credit limits and monitor the appropriateness of those limits on an ongoing basis.

Our credit exposure consists of both the risk of collecting receivables for services provided as well as the risk related to gas imbalances that occur as a regular part of the services provided in both the direct purchase market and ex-franchise market.

In the normal course of operations, we provide gas loans to other parties from our holdings of gas in storage. The replacement cost of the gas on loan at December 31, 2010 was $72 million (2009 - $39 million). We manage our credit exposure related to gas loans by subjecting these parties to the same credit policies used for all customers.

*Weather Risk*

As a primary component of Union Gas rates is volume based, the revenue levels approved by the OEB are impacted by weather. The volume forecasts used to determine the rates approved by the OEB assume normal weather conditions. Normal weather, as mandated by the OEB, is based on a 55:45 weighting of the 30-year average forecast and 20-year trend forecast respectively, for 2008 and beyond. Since a large portion of the gas distributed to the residential and commercial markets is used for space heating and is charged using volume-based rates, differences from normal weather have a significant effect on the consumption of gas and on our financial results.

*Regulatory Risk*

Our natural gas assets and operations are subject to regulation by federal, provincial and local authorities including the OEB and by various federal and provincial authorities under environmental laws. Regulation affects almost every aspect of our business, including the ability to determine terms and rates for services provided by some of our businesses, acquisitions, construction, expansion and operation of facilities, issuance of equity or debt securities, and dividend payments.

In addition, regulators in Canada have taken actions to strengthen market forces in the gas pipeline industry, which have led to increased competition. In a number of key markets, natural gas pipeline and storage operators are facing competitive pressure from a number of new industry participants, such as alternative suppliers as well as traditional pipeline competitors. Increased competition driven by regulatory changes could have a material effect on our business, earnings, financial condition and cash flows.

*Competition Risk*

As our distribution business is regulated by the OEB, it is generally not subject to third-party competition within our distribution franchise area. However, as a result of a 2006 decision by the OEB, physical bypass of newly-required facilities even within our distribution franchise area may be permitted. In addition, other companies could enter our markets or regulations could change.

Union Gas competes with other forms of energy available to its customers and end-users, including electricity, coal, propane and fuel oils. Factors that influence the demand for natural gas include price changes, the availability of natural gas and other forms of energy, the level of business activity, conservation, legislation, governmental regulations, the ability to convert to alternative fuels, weather and other factors.

*Storage Market Risk*

We have market based rates for some of our storage capacity which are based largely on seasonal natural gas market pricing spreads. To the extent that seasonal natural gas market pricing spreads deviate from historical norms or there is significant growth in the amount of storage capacity available to natural gas markets relative to demand, our approach to managing our market-based storage capacity may not protect us from significant variations in storage revenues.

*Permit Fees Risk*

Effective January 1, 2007, the Government of Ontario granted municipalities the right to charge a fee to recover the costs of issuing a permit to access pipelines located within a municipal roadway. During 2010, permit fees levied by municipalities against Union Gas did not have a significant impact on our consolidated financial statements. Should more municipalities start implementing a permit fee or if the amounts increase and these assessments become significant in the future, Union Gas will apply to the OEB to recover the annual cost of these fees in rates.

*Financing Risk*

Our business is financed to a large degree through debt. The maturity and repayment profile of debt used to finance investments often does not correlate to cash flows from assets. Accordingly, we rely on access to both short-term and long-term capital markets as a source of liquidity for capital requirements not satisfied by the cash flow from operations and to fund investments originally financed through debt. Our long-term debt is currently rated investment-grade by various rating agencies. If the rating agencies were to rate us below investment-grade, our borrowing costs would increase, perhaps significantly. In addition, we would likely be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources could decrease.

We are subject to long-term debt covenants that include a limitation on the payment of dividends, and requirements for specific interest coverage ratios prior to the issuance of additional long-term debt. Although we do not anticipate any impact to our current financing plans, reduced earnings may limit the payment of future dividends and the level of new long-term debt available to us. We maintain a revolving credit facility to backstop our commercial paper programs for short-term borrowings. This facility includes a financial covenant which limits the amount of debt that can be outstanding as a percentage of total capital. Failure to maintain this covenant could preclude us from issuing commercial paper or borrowing under the revolving credit facility and could require immediate pay down of any outstanding drawn amounts under other revolving credit agreements, which could adversely affect our cash flow.

If we are not able to access capital at competitive rates, our ability to finance operations and implement our strategy may be adversely affected. Restrictions on our ability to access financial markets may also affect our ability to execute our business plan as scheduled. An inability to access capital may limit our ability to pursue improvements or acquisitions that we may otherwise rely on for future growth. Any downgrade or other event negatively affecting the credit ratings could make our costs of borrowing higher or access to funding sources more limited.

*Human Resources Risk*

Union Gas' workforce consists of both unionized and non-unionized employees. Labour disruptions associated with the collective bargaining process can affect our ongoing operations. Projected changes in workforce demographics and a future shortage of skilled trades represent an issue that is being addressed by Union Gas.

*Performance Risk*

We have extensive contractual relationships with natural gas producers, customers, marketers, commercial enterprises, industrial companies, and others. The risk of non-performance by a contracting party may be analyzed and reduced but it cannot be entirely eliminated. Ongoing consolidation of customers and partners may increase the severity of a default.

*Litigation Risk*

Union Gas, in the course of its operations, is subject to environmental and other claims, lawsuits and contingencies. Although it is possible that liabilities may be incurred in instances for which no accruals have been made, we have no reason to believe that the ultimate outcome of such matters currently known to us could have a material effect on our consolidated financial statements.

*Facility Risk*

We carry on business through a large and complex array of natural gas transmission, storage and distribution assets. These facilities, like any other industrial operations, are subject to outages from time to time. Depending on circumstances, such outages may result in loss of revenues and/or increased maintenance costs.

*Political Risk*

The Ontario Government is operating with large deficits and significant spending commitments, in particular with commitments regarding their poverty agenda. As such it is expected that they will continue to search for new sources of revenues including non-tax revenue streams such as fees and levies. The Ontario Government also has a history of direct intervention in energy matters in the publicly owned electricity sector. This has been increasing in recent years and the risk is that the Ontario Government will intervene on the privately owned natural gas sector, some of which might affect Union Gas.

*Environmental, Health and Safety Risk*

There are a variety of hazards and operating risks inherent in natural gas storage, transmission, and distribution activities, such as leaks, explosions and mechanical problems that could cause substantial financial losses. In addition, these risks could result in significant injury, loss of human life, significant damage to property, environmental pollution and impairment of operations, any of which could result in substantial losses. For pipeline and storage assets located near populated areas, including residential areas, commercial business centers, industrial sites and other public gathering areas, the level of damage resulting from these risks could be greater. We do not maintain insurance coverage against all of these risks and losses, and any insurance coverage we might maintain may not fully cover the damages caused by those risks and losses. Therefore, should any of these risks materialize, it could have a material adverse effect on our business, earnings, financial condition and cash flows.

*Global Climate Change Risk*

The current international climate framework, the United Nations-sponsored Kyoto Protocol, prescribes specific targets to reduce GHG emissions for developed countries for the 2008-2012 periods. United Nations-sponsored international negotiations were held in Copenhagen, Denmark in December 2009 and in Cancun, Mexico in December 2010 with the intent of defining a future agreement for 2012 and beyond. While the talks resulted in a non-binding political agreement, to date, a binding successor accord to the Kyoto Protocol has not been realized.

While Canada is a signatory to the Kyoto Protocol, the Canadian federal government has confirmed it will not achieve the targets within the timeframes specified. Instead, the government in 2008 outlined a regulatory framework mandating GHG reductions from large final emitters. Regulatory design details from the Government of Canada remain forthcoming. However, Canada has reaffirmed its strong preference for a harmonized approach with that of the U.S. Regardless of the timing, we expect a number of our assets and operations will be affected by pending federal climate change regulations. However, the materiality of any potential compliance costs is unknown at this time as the final form of the regulation and compliance options has yet to be determined by policymakers.

A number of provinces are establishing or considering provincial or regional programs that would mandate reductions in GHG emissions including Ontario which is a member of the Western Climate Initiative which also includes the provinces of British Columbia, Manitoba and Quebec. However, the key details of future GHG restrictions and compliance mechanisms remain largely undefined.

Due to the uncertainty of Canadian federal and provincial policies, we cannot estimate the potential effect of proposed GHG policies on our future consolidated results of operations, financial position or cash flows. However such legislation could increase our operating costs materially, require material capital expenditures or create additional permitting, which could delay proposed construction projects.

*Protecting Against Potential Terrorist Activities*

The potential for terrorism because of the high profile of the natural gas industry has subjected our operations to increased risks that could have a material adverse effect on our business. This risk is particularly great for companies, like ours, operating in any energy infrastructure industry that handles volatile gaseous and liquid hydrocarbons. The potential for terrorism has subjected our operations to increased risks that could have a material adverse effect on our business. In particular, we may experience increased capital and operating costs to implement increased security for our facilities and pipelines, such as additional physical facility and pipeline security and additional security personnel. Moreover, any physical damage to high profile facilities resulting from acts of terrorism may not be covered, or covered fully, by insurance. We may be required to expend material amounts of capital to repair any facilities, the expenditure of which could adversely affect our cash flows and business.

Changes in the insurance markets attributable to terrorist attacks may make certain types of insurance more difficult for us to obtain. Moreover, the insurance that may be available to us may be significantly more expensive than our existing insurance coverage. Instability in the financial markets as a result of terrorism or war could also affect our ability to raise capital.

*Pension Risk*

Our costs of providing defined benefit pension plans are dependent upon a number of factors, such as the rates of return on plan assets, discount rates used to measure pension liabilities, actuarial gains and losses, future government regulation and our contributions made to the plans. Without sustained growth in the pension plan investments over time to increase the value of our plan assets, and depending upon the other factors impacting our costs as listed above, we could experience net asset, expense and funding volatility. This volatility could have a material effect on our earnings and cash flows.

*Land Rights*

Certain aboriginal groups in Ontario have also claimed aboriginal and treaty rights in areas where Union Gas' Dawn storage and transmission assets are located and also in areas where the Dawn-Trafalgar pipeline route is located. The existence of these claims could give rise to future uncertainty regarding land tenure depending upon their negotiated outcome.

## CERTIFICATION OF DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING

### Disclosure Controls and Procedures

Disclosure controls and procedures are controls and other procedures that are designed to: (a) provide reasonable assurance that material information required to be disclosed by us is accumulated and communicated to management to allow timely decisions regarding required disclosure; and (b) ensure that material information required to be disclosed by us is recorded, processed, summarized, and reported within the time periods specified in applicable securities legislation.

Our management, with the participation of the President and the Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2010, and, based upon this evaluation, the President and the Chief Financial Officer have concluded that these disclosure controls and procedures, as defined by the Companion Policy 52-109CP to National Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings (NI 52-109)*, are effective for the purposes set out above.

### Internal Control over Financial Reporting

Our management is responsible for designing, establishing and maintaining an adequate system of internal control over financial reporting. Our internal control system was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes, in accordance with Canadian GAAP. Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

Our management, with the participation of our President and the Chief Financial Officer, has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2010 based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on that evaluation, management concluded that our internal control over financial reporting, as defined by the Companion Policy 52-109CP to NI 52-109, is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP.

### Changes in Internal Control over Financial Reporting

Under the supervision and with the participation of management, including the President and Chief Financial Officer, we have evaluated changes in internal control over financial reporting that occurred during the fiscal quarter and year ended December 31, 2010 and found no change that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

Our Board of Directors reviewed and approved the 2010 audited consolidated financial statements and this management's discussion and analysis prior to its release.

## CRITICAL ACCOUNTING POLICIES & ESTIMATES

The application of accounting policies and estimates is an important process that continues to evolve as Union Gas' operations change and accounting guidance is issued. Union Gas has identified a number of critical accounting policies and estimates that require the use of significant estimates and judgments.

Management bases its estimates and judgments on historical experience and on other various assumptions that they believe are reasonable at the time of application. The estimates and judgments may change as time passes and more information becomes available. If estimates and judgments are different than the actual amounts recorded, adjustments are made in subsequent periods to take into consideration the new information. Union Gas discusses its critical accounting policies and estimates and other significant accounting policies with senior members of management and the Board of Directors.

*Regulatory Accounting*

Union Gas follows Canadian GAAP, which allows accounting treatments that may differ for rate-regulated operations from those otherwise expected in non rate-regulated businesses. As a result, we record assets and liabilities that result from the regulated ratemaking process that may not be recorded under GAAP for non rate-regulated entities. Regulatory assets generally represent incurred costs that have been deferred because they are probable of future recovery in customer rates. Regulatory liabilities generally represent obligations to make refunds to ratepayers. Management continually assesses whether the regulatory assets are probable of future recovery by considering factors such as applicable regulatory changes and recent rate orders to other rate-regulated entities. Management believes the existing regulatory assets are probable of recovery. This determination reflects the current political and regulatory climate and is subject to change in the future. If future recovery of costs ceases to be probable, asset write-offs could be required to be recognized in current period earnings.

*Unbilled Revenue*

Revenues from the transportation, storage, distribution and sales of natural gas are recognized when either the service is provided or the product is delivered. Revenues related to these services provided or products delivered but not yet billed are estimated each month. Gas sales and distribution revenue and cost of gas are recorded on the basis of regular meter readings and estimates of the unbilled customer usage. The unbilled estimate covers the period of the last meter reading date to the end of each month and is calculated using the number of days unbilled, heating degree-days and historical consumption per heating degree-day. Unbilled revenue recorded at December 31, 2010 was $118 million (2009 – $100 million). Differences between actual and estimated unbilled revenues are not material to net income. Included in unbilled revenue are natural gas costs passed through to customers without a mark-up. At December 31, 2010 $73 million (2009 – $54 million) was included in unbilled revenue for the cost of natural gas.

*Employee Future Benefits*

Critical estimates and assumptions relating to our defined benefit pension plans are required to account for employee future benefits. Changes to these estimates and assumptions could result in a material difference to our employee future benefit plan obligation.

The following is a summary of the sensitivity of key assumptions used to record the employee future benefit liability:

**Sensitivity of key assumptions**

| *($millions)* | **Registered Pension Plan and Supplemental Pension Arrangements** | | **Post-Retirement Benefits Other than Pensions** | |
|---|---|---|---|---|
| Assumed change in: | **1% Increase** | **1% Decrease** | **1% Increase** | **1% Decrease** |
| Discount rate | | | | |
| Change in 2010 net periodic benefit cost | **(7)** | 7 | **(1)** | 1 |
| Change in benefit obligation | **(72)** | 81 | **(9)** | 10 |
| Health care cost trend rate | | | | |
| Change in 2010 net periodic benefit cost | **N/A** | N/A | **1** | (1) |
| Change in benefit obligation | **N/A** | N/A | **6** | (6) |
| Expected rate of return on assets | | | | |
| Change in 2010 net periodic benefit cost | **(5)** | 5 | **N/A** | N/A |

## FUTURE ACCOUNTING CHANGES

*Transition to International Financial Reporting Standards (IFRS)*

In February 2008, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) confirmed that publicly accountable enterprises will be required to adopt IFRS in place of GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

In September, 2010, the AcSB offered an optional one year deferral to adopt IFRS for qualifying entities with rate regulated activities and permit such entities to continue to apply Part V – Pre changeover accounting standards of the CICA Handbook during that period. The Company is a qualifying entity for purposes of this deferral.

While the Company's IFRS conversion project was on track to meet the original conversion deadline, we have elected to use the deferral offered by the AcSB. This decision was made to allow us to convert at the same time as many companies in our industry, and to review our reporting options, including registering with the Securities and Exchange Commission (SEC) of the United States, so that we could report under U.S. GAAP instead of IFRS.

At this time, it is the Company's intention to take the steps necessary to report under U.S. GAAP starting in 2012.

The consolidated financial statements and all information in this report have been prepared by and are the responsibility of management. The consolidated financial statements have been prepared in conformity with Canadian generally accepted accounting principles and include certain estimated amounts, which are based on informed judgements to ensure fair representation in all material respects. When alternative accounting methods exist, management has chosen those it considers most appropriate.

Management depends upon Union Gas' system of internal controls and formal policies and procedures to ensure the consistency, integrity and reliability of accounting and financial reporting, and to provide reasonable assurance that assets are safeguarded and that transactions are properly executed in accordance with management's authorization. Management is also supported and assisted by a program of internal audit services.

The Board of Directors is responsible for ensuring that management fulfils its responsibility for financial reporting and for final approval of the consolidated financial statements.

The Board of Directors meets regularly with management, the internal auditors and the shareholders' auditors to review the consolidated financial statements, the Independent Auditor's Report and other auditing and accounting matters to ensure that each group is properly discharging its responsibilities.

The shareholders' auditors have full and free access to the Board of Directors, as does the Director of Internal Audit Services.

Deloitte & Touche LLP performed an independent audit of the 2010 and 2009 consolidated financial statements in this report. Their independent professional opinion on the fairness of these consolidated financial statements is included in the Independent Auditor's Report.

March 16, 2011

Julie Dill
President

J. Patrick Reddy
Chief Financial Officer

Deloitte.

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# Independent Auditor's Report

To the Shareholders of
Union Gas Limited

We have audited the accompanying consolidated financial statements of Union Gas Limited, which comprise the consolidated balance sheets as at December 31, 2010 and December 31, 2009, and the consolidated statements of income and comprehensive income, retained earnings, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

## Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Union Gas Limited as at December 31, 2010 and December 31, 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Chartered Accountants
Licensed Public Accountants
March 16, 2011

## UNION GAS LIMITED
## Consolidated Statements of Income and Comprehensive Income

| *For the Years Ended December 31 ($millions)* | **2010** | 2009 |
|---|---|---|
| Gas sales and distribution revenue | **1,493** | 1,684 |
| Cost of gas (note 15) | **794** | 1,026 |
| Gas distribution margin | **699** | 658 |
| Storage and transportation revenue (note 15) | **308** | 299 |
| Other revenue | **29** | 36 |
| | **1,036** | 993 |
| Expenses | | |
| Operating and maintenance (note 15) | **364** | 345 |
| Depreciation and amortization (note 5) | **200** | 195 |
| Property and capital taxes | **67** | 68 |
| | **631** | 608 |
| Income before other items | **405** | 385 |
| Other (income) and expenses, net | **–** | 2 |
| Income before interest and income taxes | **405** | 383 |
| Interest expense (notes 6 and 15) | **158** | 160 |
| Income before income taxes | **247** | 223 |
| Income taxes (note 14) | **41** | 48 |
| Net income and comprehensive income | **206** | 175 |
| Preference share dividends | **2** | 2 |
| Net income applicable to common shares | **204** | 173 |

(*See accompanying notes)*

## UNION GAS LIMITED
## Consolidated Statements of Retained Earnings

| *For the Years Ended December 31 ($millions)* | **2010** | 2009 |
|---|---|---|
| Retained earnings, beginning of year | **696** | 688 |
| Net income and comprehensive income | **206** | 175 |
| Dividends | | |
| Preference shares | **(2)** | (2) |
| Common shares | **(190)** | (165) |
| Retained earnings, end of year | **710** | 696 |

(*See accompanying notes)*

## UNION GAS LIMITED
### Consolidated Balance Sheets

| *As at December 31 ($millions)* | **2010** | 2009 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash and cash equivalents | **12** | 34 |
| Accounts receivable (notes 3 and 15) | **516** | 401 |
| Inventories (note 4) | **174** | 224 |
| Future income taxes (note 14) | **14** | 57 |
| Total current assets | **716** | 716 |
| Property, plant and equipment (note 5) | | |
| Cost | **6,370** | 6,187 |
| Accumulated depreciation | **1,994** | 1,884 |
| Net property, plant and equipment | **4,376** | 4,303 |
| Regulatory and other assets (note 13) | **493** | 427 |
| **Total Assets** | **5,585** | 5,446 |
| | | |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities | | |
| Short-term borrowings (note 15) | **198** | – |
| Commercial paper (note 6) | **157** | 39 |
| Accounts payable and accrued charges (notes 3 and 15) | **582** | 794 |
| Income taxes payable (note 14) | **8** | 79 |
| Long-term debt (note 6) | **250** | 222 |
| Total current liabilities | **1,195** | 1,134 |
| Long-term liabilities | | |
| Long-term debt (note 6) | **1,978** | 1,979 |
| Mandatorily redeemable preference shares (note 7) | **5** | 5 |
| Future income taxes (note 14) | **361** | 327 |
| Asset retirement obligations (note 9) | **123** | 108 |
| Regulatory and other liabilities (note 13) | **472** | 455 |
| Total long-term liabilities | **2,939** | 2,874 |
| **Total Liabilities** | **4,134** | 4,008 |
| | | |
| Non-controlling interest | **9** | 10 |
| | | |
| Shareholders' equity | | |
| Share capital (note 8) | **732** | 732 |
| Retained earnings | **710** | 696 |
| **Total Shareholders' Equity** | **1,442** | 1,428 |
| **Total Liabilities and Shareholders' Equity** | **5,585** | 5,446 |

*(See accompanying notes)*

**Approved by the Board**

Director

Director

**UNION GAS LIMITED**
**Consolidated Statements of Cash Flows**

| *For the Years Ended December 31 ($millions)* | **2010** | 2009 |
|---|---|---|
| **Operating Activities** | | |
| Net income | **206** | 175 |
| Items not affecting cash | | |
| Depreciation and amortization | **200** | 195 |
| Future income taxes | **25** | (55) |
| Changes in working capital | | |
| Accounts receivable | **(42)** | 167 |
| Inventories | **32** | 26 |
| Account payables, accrued charges and other | **(247)** | 134 |
| | **174** | 642 |
| **Investing Activities** | | |
| Capital expenditures | **(232)** | (247) |
| **Financing Activities** | | |
| Net increase (decrease) in short-term borrowings | **198** | (115) |
| Net increase (decrease) in commercial paper | **118** | (167) |
| Long-term debt issued | **250** | – |
| Long-term debt repayments | **(222)** | (29) |
| Dividends paid | **(308)** | (50) |
| | **36** | (361) |
| Change in cash and cash equivalents, during the year | **(22)** | 34 |
| Cash and cash equivalents, beginning of year | **34** | – |
| Cash and cash equivalents, end of year | **12** | 34 |
| **Supplementary Disclosure of Cash Flow Information:** | | |
| Cash payments of interest | **152** | 164 |
| Cash payments of income taxes | **96** | 47 |

*(See accompanying notes)*

**UNION GAS LIMITED**
**Notes to Consolidated Financial Statements**
**December 31, 2010 and 2009**

Union Gas Limited (Union Gas or the Company) owns and operates natural gas transmission, distribution and storage facilities in Ontario. The Company distributes natural gas to customers in northern, southwestern and eastern Ontario and provides natural gas storage and transportation services for other utilities and energy market participants. The property, plant and equipment of the Company consist primarily of pipeline, storage and compression facilities used in the transportation, storage and distribution of natural gas. In total, the Company has approximately 5,000 kilometres of high-pressure transmission pipeline and approximately 60,600 kilometres of distribution main and service pipelines. The Company's underground natural gas storage facilities have a working capacity of more than 155 billion cubic feet (Bcf).

## 1. Significant Accounting Policies

### Accounting Principles

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and certain transactions have been recorded using accounting principles for rate-regulated enterprises as discussed below under "Regulation." The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities. Actual amounts could differ from these estimates. Management's significant estimates include unbilled revenue, income tax expense, employee future benefit expense, estimated useful life of property, plant and equipment and asset retirement obligations.

### Accounting Changes

*Rate-regulated Operations*

Effective January 1, 2009, amendments have been made to certain sections of the Canadian Institute of Chartered Accountants (CICA) Handbook related to rate-regulated accounting.

CICA Section 3465, Income Taxes has been amended to require rate-regulated enterprises to recognize future income tax assets and liabilities. This amendment also requires that a regulatory asset or liability for the amount of future income taxes expected to be recovered from or refunded to ratepayers, and to present these amounts on a pre-tax basis in the financial statements. The impact of these changes resulted in an increase in regulatory and other assets and an increase in future income tax liabilities of $273 million on January 1, 2009.

CICA Section 1100, Generally Accepted Accounting Principles has been amended to remove a temporary exemption pertaining to the application of the recognition and measurement of assets and liabilities arising from rate regulation. In the absence of specific guidance the CICA has permitted reliance on another source of GAAP, specifically the Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS 71). Since FAS 71 does not specifically address depreciation methods, Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (FAS 143) applies to entities that meet FAS 71. FAS 143 requires asset removal costs to be reported as a regulatory liability. Prior to 2009, asset removal costs were included in property, plant and equipment. This reclassification resulted in an increase in property, plant and equipment and an increase in regulatory liabilities of $402 million on January 1, 2009.

### Principles of Consolidation

The consolidated financial statements of the Company include the accounts of Union Gas and its subsidiary, Huron Tipperary Limited Partnership I, of which the Company owns 75%.

**Regulation**

The Company is regulated by the Ontario Energy Board (OEB) pursuant to the provisions of the *Ontario Energy Board Act* (1998), which is part of a package of legislation known as *The Energy Competition Act* (1998). This legislation provides an opportunity for different forms of regulation and increased competition in the energy (electricity and natural gas) industry in Ontario. The Company is subject to regulation with respect to the rates that it may charge its customers, with the exception of the items noted below, system expansion or facility abandonment, adequacy of service, public safety aspects of pipeline system construction and certain accounting principles. The OEB has determined that it will forbear from regulating the prices for long-term storage services. The Storage Forbearance Decision created an unregulated storage operation within Union Gas and provides the framework required to support new storage investments.

The OEB is mandated to approve rates that are just and reasonable. Utility earnings are regulated by the OEB under cost of service regulation, on the basis of a return on rate base for a future period. Under cost of service regulation, a rate application process leads to the implementation of new rates intended to provide a utility with the opportunity to earn an allowed rate of return. The actual rate of return achieved by the Company may vary from the rate allowed by the OEB as a result of unexpected changes in weather, average use per customer, inflation, the price of competing fuels, interest rates, general economic conditions and its ability to achieve forecast revenues and manage costs.

Rates effective January 1, 2007 were approved by the OEB on the basis of the traditional cost of service framework. Effective January 1, 2008, the Company began a five year incentive regulation term. The incentive regulation framework establishes new rates at the beginning of each year through the use of a pricing formula rather than through the examination of revenue and cost forecasts. The Company is expecting to set rates for 2013 on a cost of service basis.

The Company follows Canadian GAAP, which may differ for regulated operations from those otherwise expected in non rate-regulated businesses. As a result, the Company records assets and liabilities that result from the regulated ratemaking process that may not be recorded under GAAP for non rate-regulated entities. Regulatory assets generally represent incurred costs that have been deferred because they are probable of future recovery in customer rates. Regulatory liabilities generally represent obligations to make refunds to customers for previous collections for costs that are not likely to be incurred, or for certain net revenues beyond a pre-established threshold. Management continually assesses whether the regulatory assets are probable of future recovery by considering factors such as applicable regulatory changes and recent rate orders to other regulated entities. Management believes the existing regulatory assets are probable of recovery. This determination reflects the current political and regulatory climate at the provincial and national levels, and is subject to change in the future. If future recovery of costs ceases to be probable, the asset write-offs could be recognized in current period earnings.

**Revenue Recognition**

Revenues from the transportation, storage, distribution and sales of natural gas are recognized when either the service is provided or the product is delivered. Revenues related to these services provided or products delivered but not yet billed are estimated each month.

**Gas Sales and Cost of Gas**

Gas sales revenue is recorded on the basis of regular meter readings and estimates of customer volume usage since the last meter reading date to the end of the reporting period applied using OEB approved rates. Cost of gas is recorded using amounts approved by the OEB in the determination of customer sales rates. Differences between the OEB approved reference amounts and those costs actually incurred are deferred in either accounts receivable or accounts payable and accrued charges for future disposition subject to approval by the OEB.

In determining the quantities of gas delivered and received, differences arise from the measurement process. The Company includes in the cost of gas an estimated amount of these differences based upon the methodology used by the OEB in the determination of rates for storage, transmission and distribution of gas. Annual fluctuations from the estimated level are recognized in earnings during the year.

As part of the Company's OEB-approved incentive regulation framework, an earnings sharing mechanism exists whereby earnings above an allowable return on equity are shared with ratepayers. A provision of $4 million was recognized as a reduction of gas sales and distribution revenue and as an obligation in accounts payable and accrued charges for 2010 (2009 – $4 million). Also in 2009, the Company recorded an $11 million charge as a result of a settlement agreement reached with Union Gas' stakeholders with regard to our 2008 utility earnings.

**Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and short-term investments, with an original maturity of three months or less.

**Income Taxes**

The asset and liability method of tax allocation is used in the accounting for income taxes for Under this method, future income tax assets and liabilities are recognized for differences between the financial reporting and tax basis of assets and liabilities at enacted, or the substantively enacted, tax rates in effect for the years in which the differences are expected to reverse.

**Inventories**

Gas in storage for resale to customers is carried at costs approved by the OEB in the determination of customer sales rates. The difference between the approved cost and the actual cost of the gas purchased is deferred in either accounts receivable or accounts payable and accrued charges for future disposition subject to approval by the OEB. Inventories of materials and supplies are valued at the lower of cost or net realizable value.

**Property, Plant and Equipment and Depreciation**

Property, plant and equipment are carried at cost which includes all direct costs, overhead attributable to construction and interest capitalized during construction. The cost of property, plant and equipment is reduced by contributions and grants in aid of construction received from customers and governmental bodies in support of specific transmission and distribution facilities.

Regulated depreciation is provided on the straight-line method at various rates based on the average service life of each class of property. Unregulated depreciation rates are based on useful life.

Regulated depreciation rates are determined by periodic review. The depreciation rates for regulated property, plant and equipment are approved by the OEB. Unregulated depreciation rates are determined by management.

When Union Gas retires regulated property, plant and equipment, the Company charges the original cost plus the cost of retirement, less salvage value, to accumulated depreciation and amortization. When the Company sells entire regulated operating units, or retire non-regulated properties, the cost is removed from the property account and the related accumulated depreciation and amortization accounts are reduced. Any gain or loss is recorded in earnings, unless otherwise required by the OEB.

**Asset Retirement Obligations**

The Company recognizes the fair value of an asset retirement obligation (ARO), where a legal obligation exists, as a liability in the period in which it is incurred provided a reasonable estimate of fair value can be determined. The associated asset retirement cost is added to the carrying amount of the related asset. The liability is accreted over the estimated life of the related asset.

**Stock-Based Compensation**

Our employees participate in a stock-based compensation plan sponsored by Spectra Energy Corp (Spectra Energy). For employee awards, equity classified stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which generally begins on the date the award is granted through the earlier of the date the award vests or the date the employee becomes retirement eligible. Awards, including stock options, granted to employees that are already retirement eligible are deemed to have vested immediately upon issuance, and therefore, compensation cost for those awards is recognized on the date such awards are granted.

In addition, certain of our employees that previously participated in our 1989 Long Term Incentive Share Plan have the ability to receive a portion of their converted stock option awards as a stock appreciation right (SAR) paid in cash. Union Gas accounts for these by measuring the amount by which the quoted market price of the underlying stock exceeds the SAR base stock price at the balance sheet date.

**Employee Benefit Plans**

The Company uses the projected benefit method prorated on services to account for defined benefit pension and post-retirement benefits other than pensions earned by employees.

The Company accrues obligations under employee benefit plans and the related costs, net of plan assets. The plan assets are valued at fair value. The calculation of the expected return on assets is based on the market-related value of assets with the market related adjustment determined over a three-year period.

Past service costs from plan amendments are amortized on a straight-line basis over the average remaining service life of employees active at the date of amendment.

The amount by which the net unamortized cumulative actuarial gain or loss exceeds ten percent of the greater of the accrued benefit obligation or the market-related value of plan assets at the beginning of the year is amortized over the expected average remaining service period of the active employees.

The average remaining service period of active employees covered by the pension plans and the post-retirement benefits other than pension plans is 10 and 18 years, respectively.

For defined contribution plans maintained by the Company, contributions payable by the Company are expensed as pension costs in the period incurred.

## 2. Financial Statement Effects of Rate Regulation

The Company records assets and liabilities that result from the regulated ratemaking process that would not be recorded under GAAP for non-regulated entities. See note 1 for further discussion.

| ($millions) | Financial Statement Location | Recovery/ Settlement Period | **December 31 2010** | December 31 2009 |
|---|---|---|---|---|
| **Assets** | | | | |
| Other deferrals – current | a | A | **12** | 22 |
| Gas in storage inventory | b | A | **28** | 37 |
| Other deferrals – long-term | c | B | **3** | 4 |
| Future income taxes – long-term | c | B/C | **214** | 174 |
| Total assets | | | **257** | 237 |
| **Liabilities** | | | | |
| Other deferrals – current | d | A | **31** | 37 |
| Gas cost deferrals | d | A | **39** | 186 |
| Storage and transportation deferrals | d | A | **9** | 20 |
| Asset removal costs | e | C | **409** | 398 |
| Total liabilities | | | **488** | 641 |

In the absence of rate regulation, the Company's future income tax asset (current) would have been $20 million lower in 2010 (2009 - $68 million lower), and the future income tax liability (long-term) would have been $48 million higher in 2010 (2009 - $58 million higher) as a result of the elimination of the above regulatory assets and liabilities.

*Financial Statement Classification*

(a) Accounts receivable
(b) Inventories
(c) Regulatory and other assets
(d) Accounts payable and accrued charges
(e) Regulatory and other liabilities

*Recovery/Settlement Period*

(A) Remaining recovery / settlement is less than 1 year
(B) Remaining recovery / settlement is from 2 to 10 years
(C) Remaining recovery / settlement is over the remaining life of the associated assets

*Other deferrals – current*

As prescribed by regulatory order, the Company has various amounts included in customer rates that are intended to recover specifically-identified costs. To the extent that the actual costs differ from forecast costs or revenues, the variance is deferred for future recovery from or refund to ratepayers. In the absence of rate regulation, after-tax earnings for 2010 could have been $3 million higher (2009 - $8 million higher) because GAAP for non-regulated entities would require that all customer rate revenue and costs be recognized in income when earned.

*Gas in storage*

Gas in storage is carried at the weighted average cost of gas as approved by the OEB. In the absence of rate regulation, after-tax earnings for 2010 could have been $9 million higher (2009 - $3 million higher), because GAAP for non-regulated entities would require that gas in storage be recorded at the lower of cost and net realizable value.

*Future income taxes*

The accounting standard related to income taxes has been amended to require rate-regulated enterprises to recognize future income tax assets and liabilities, and an associated regulatory asset or liability, if applicable, for the amount of future income taxes expected to be recovered from or refunded to ratepayers, and to present these amounts on a gross basis in the financial statements. In the absence of rate regulation, after-tax earnings for 2010 could have been $39 million lower (2009 - $29 million higher) because GAAP for non-regulated entities would require that these amounts be recognized in earnings in the current period.

*Gas cost deferrals*

The Company and the OEB have a mechanism in place to change gas commodity rates on a quarterly basis, to ensure that customers' rates reflect future expected costs based on published forward market prices. The difference between the approved and the actual cost of gas incurred is deferred for future recovery from or repayment to customers. These deferred amounts are subject to review and approval by the OEB on an annual basis in the normal course. The regulatory asset or liability represents the difference between actual gas commodity costs incurred and the amount included in approved rates. In the absence of rate regulation, after-tax earnings for the 2010 could have been $101 million lower (2009 - $115 million higher), because GAAP for non-regulated entities would require that actual commodity costs be recognized as an expense when incurred.

*Storage and transportation deferrals*

The Company earns revenue for providing storage and transportation services to customers. The forecast of this revenue is one component used to establish Union Gas' rates for services. Storage and transportation deferral accounts accumulate any difference between the actual revenue earned in providing these storage and transportation services and the forecast revenue approved by the OEB for rate-making purposes. In the absence of rate regulation, GAAP for non-regulated entities would require that actual storage and transportation revenue be recognized in income when earned. After-tax earnings for 2010 could have been $8 million lower (2009 - $9 million lower), if these transactions were accounted for under GAAP for non-regulated entities.

*Asset removal costs*

The Company has recorded a regulatory liability, included in deferred credits and other liabilities, as a result of estimated removal costs for property that does not have an associated legal retirement obligation. In the absence of rate regulation, these costs may not have been recorded and after-tax earnings for 2010 could have been $8 million higher (2009 - $3 million lower).

*Property, plant and equipment*

In the absence of rate regulation, property, plant and equipment may not include overhead costs since these costs may have been charged to earnings in the period in which they occurred. As such, annual operating and maintenance costs could have been higher by the amounts capitalized and depreciation could be lower due to the impact of lower capitalized costs. These amounts are not readily determinable.

## 3. Gas Imbalances

The Company, in the normal course of its operations, experiences imbalances in natural gas volumes between interconnecting pipelines and provides gas balancing services to customers. Natural gas volumes owed to or from the Company are valued at natural gas market prices as of the balance sheet dates. As the settlement of imbalances is done with gas volumes, changes in the balances do not have an impact on the Company's cash flow from operating activities.

At December 31, 2010 accounts receivable and accounts payable include approximately $194 million (2009 – $102 million) related to gas imbalances and gas balancing services.

## 4. Inventories

| ($millions) | **December 31 2010** | December 31 2009 |
|---|---|---|
| Gas in storage | **157** | 208 |
| Materials and supplies | **17** | 16 |
| | **174** | 224 |

Gas in storage includes gas for delivery to customers and for use in the Company's operations. Inventories of materials and supplies are used in the operation and maintenance of the Company's system.

## 5. Property, Plant and Equipment, net

| ($millions) | **December 31 2010** | December 31 2009 |
|---|---|---|
| **Cost** | | |
| Distribution | **3,594** | 3,483 |
| Transmission | **1,639** | 1,596 |
| Storage | **870** | 845 |
| General | **267** | 263 |
| | **6,370** | 6,187 |
| **Accumulated depreciation** | | |
| Distribution | **1,086** | 1,028 |
| Transmission | **498** | 460 |
| Storage | **277** | 267 |
| General | **133** | 129 |
| | **1,994** | 1,884 |
| Net book value | **4,376** | 4,303 |

The depreciation range of each class of property is as follows:

| | |
|---|---|
| Distribution | 27-60 years |
| Transmission | 30-50 years |
| Storage | 5-50 years |
| General | 4-38 years |

Depreciation rates used during the year ended December 31, 2010 resulted in a composite rate of 3.26% (2009 – 3.32%).

Included in property, plant and equipment are the following:

| ($millions) | **December 31 2010** | December 31 2009 |
|---|---|---|
| Assets not subject to depreciation[12] | **161** | 128 |
| Asset retirement cost | **35** | 32 |
| Interest charge capitalized during the year | **1** | 4 |

[12] Assets not subject to depreciation include land, base pressure gas in storage reservoirs and assets under construction.

## 6. Debt and Credit Facility

### Long-term Debt

| *($millions)* | | **December 31 2010** | December 31 2009 |
|---|---|---|---|
| Sinking fund debentures | | | |
| 11.55% | 1988 Series II debentures, redeemed October 2010 | **–** | 37 |
| Medium-term note debentures | | | |
| 7.20% | Series 2, redeemed June 2010 | **–** | 185 |
| 6.65% | Series 3, due May 4, 2011 | **250** | 250 |
| 4.64% | Series 5, due June 30, 2016 | **200** | 200 |
| 5.35% | Series 6, due April 27, 2018 | **200** | 200 |
| 4.85% | Series 7, due April 25, 2022 | **125** | 125 |
| 5.46% | Series 6, due September 11, 2036 | **165** | 165 |
| 6.05% | Series 7, due September 2, 2038 | **300** | 300 |
| 5.20% | Series 8, due July 23, 2040 | **250** | – |
| Other debentures | | | |
| 7.90% | 1994 Series debentures, due February 24, 2014 | **150** | 150 |
| 11.50% | 1990 Series debentures, due August 28, 2015 | **150** | 150 |
| 9.70% | 1992 Series II debentures, due November 6, 2017 | **125** | 125 |
| 8.75% | 1993 Series debentures, due August 3, 2018 | **125** | 125 |
| 8.65% | Senior debentures, due October 19, 2018 | **75** | 75 |
| 8.65% | 1995 Series debentures, due November 10, 2025 | **125** | 125 |
| | | **2,240** | 2,212 |
| Less: deferred financing charges | | **12** | 11 |
| | | **2,228** | 2,201 |
| Less: current portion | | **250** | 222 |
| | | **1,978** | 1,979 |

The Company's long-term debt is unsecured. The weighted average cost of long-term debt as at December 31, 2010 was 6.8% (2009 – 7.1%). Principal repayment requirements on long-term debt are as follows:

| *($millions)* | Total | 2011 | 2012 | 2013 | 2014 | 2015 | Thereafter |
|---|---|---|---|---|---|---|---|
| Long-term debt | 2,240 | 250 | – | – | 150 | 150 | 1,690 |

Under the terms of the trust indentures relating to certain debentures, the Company has agreed to several covenants including a limitation on the payment of dividends. As of December 31, 2010 and 2009, the Company is in compliance with all such covenants.

Total interest paid on long-term debt in 2010 was $150 million (2009 – $160 million).

### Available Credit Facility and Restrictive Debt Covenants

| | **Expiration Date** | **Credit Facility Capacity** | **Outstanding at December 31, 2010 Commercial Paper** |
|---|---|---|---|
| Multi-year syndicated[13] | 2012 | 500 | 157 |

[13] Credit facility contains a covenant requiring the debt-to-total capitalization ratio to not exceed 75% and a provision which requires Union Gas to repay all borrowings under the facility for a period of two days during the second quarter of each year.

The issuance of commercial paper and other facility borrowings reduces the amount available under the credit facility.

The Company's credit agreement contains various financial and other covenants, including the maintenance of certain financial ratios. Failure to meet those covenants beyond applicable grace periods could result in accelerated due dates and/or termination of the agreement. As of December 31, 2010, the Company was in compliance with those covenants. In addition, the credit agreement allows for the acceleration of payments or termination of the agreement due to non-payment, or in some cases, due to the acceleration of other significant indebtedness of the borrower or some of its subsidiaries.

A majority of the Company's short-term cash requirements are funded through the issuance of commercial paper. The weighted average rate on outstanding commercial paper as of December 31, 2010 was 1.05% (2009 – 0.4%).

Total interest paid on short-term debt in 2010 was $2 million (2009 – $4 million).

## 7. Mandatorily Redeemable Preference Shares

| | | Outstanding at December 31 | | | |
|---|---|---|---|---|---|
| **Authorized** | | **2010** | 2009 | **December 31 2010** | December 31 2009 |
| *(shares)* | | *(shares)* | | *($millions)* | |
| Class A – 112,072 | Series A, 5.5% | **47,672** | 47,672 | **3** | 3 |
| | Series C, 5.0% | **49,500** | 49,500 | **2** | 2 |
| | | | | **5** | 5 |

The Class A, Series A and C Preference Shares are cumulative and redeemable at $50.50 per share. The Company is obligated to offer to purchase $170,000 of Series A and $140,000 of Series C shares annually at the lowest price obtainable, but not exceeding $50 per share.

## 8. Share Capital

| | | Outstanding at December 31 | | | |
|---|---|---|---|---|---|
| | **Authorized** | **2010** | 2009 | **December 31 2010** | December 31 2009 |
| | *(shares)* | *(shares)* | | *($millions)* | |
| Class A, Series B, 6% | 90,000 | **90,000** | 90,000 | **5** | 5 |
| Class B, Series 10, 4.88% | Unlimited | **4,000,000** | 4,000,000 | **100** | 100 |
| | | | | **105** | 105 |
| Common Shares | Unlimited | **57,822,650** | 57,822,650 | **627** | 627 |
| | | | | **732** | 732 |

The Class A, Series B Preference Shares are cumulative and redeemable at $55 per share at the option of the Company.

The Class B, Series 10 Preference Shares are cumulative and redeemable at $25 per share at the option of the Company and, at the option of the holders, convertible back into Series 11 shares every five years commencing January 1, 2014. Union Gas may redeem at any time all, but not less than all, of the outstanding Series 10 Shares. The dividend rate of the Series 10 Shares is floating at an annual rate equal to 80% of the prime rate until December 31, 2013.

## 9. Asset Retirement Obligation

The Company has a legal obligation to disconnect, purge and cap abandoned pipeline, as well as capping abandoned storage wells. The Company also has buildings that contain asbestos and therefore will have a legal obligation requiring the special handling and disposition of the asbestos if it is disturbed.

The Company has non-asbestos AROs which include easements and some railway license agreements relating to pipeline assets located on land which the Company does not own. The Company has not recognized a liability in regard to these non-asbestos ARO because the fair value of the ARO cannot be reasonably estimated. The Company's pipeline system is considered a critical component of its business and is expected to be maintained and remain in place indefinitely. Natural gas supplies are also considered sufficient for the Company to operate in the long-term. The Company has determined that sufficient information to estimate the fair value of an ARO is not available because the assets are considered permanent with indeterminate useful lives and that sufficient information is not available to estimate a range of potential settlement dates in order to employ a present value technique to estimate fair value.

At December 31, 2010, the estimated undiscounted cash flows required to settle our AROs was $587 million (2009 – $573 million), calculated using an inflation rate of 2.0% per annum (2009 – 2.0%). The estimated fair value of this liability was $123 million (2009 – $108 million). The estimated cash flows of new obligations incurred during the year have been discounted at a rate of 3.80% per annum (2009 – 4.22%). At December 31, 2010, the timing of payment for settlement of the obligations ranges from 1 to 147 years.

Reconciliation of Asset Retirement Obligations:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Balance, beginning of year | **108** | 75 |
| Liabilities incurred | **10** | 32 |
| Liabilities settled | **(1)** | (3) |
| Accretion | **6** | 4 |
| Balance, end of year | **123** | 108 |

## 10. Stock-Based Compensation

Under the Long Term Incentive Share Option Plan 1989 ("1989 Plan"), the Company's parent company, Westcoast Energy Inc. (Westcoast) has granted certain stock options to its employees, including employees of Union Gas. Stock options are granted at an exercise price that equals the market price as defined in the 1989 Plan of Westcoast's shares on the date of grant. The 1989 Plan also provides for share appreciation rights under which the holder of a stock option may, in lieu of exercising the option, exercise the share appreciation right.

The Spectra Energy 2007 Long-Term Incentive Plan (the 2007 LTIP) provides for the granting of stock options, restricted stock awards and units, unrestricted stock awards and units, and other equity-based awards, to employees and other key individuals who perform services for Spectra Energy. A maximum of 30 million shares of common stock may be awarded under the 2007 LTIP. Union Gas employees participate in the 2007 LTIP. Options granted under the 2007 LTIP are issued with exercise prices equal to the fair market value of the Spectra Energy common stock on the grant date, have ten year terms and vest immediately or over terms not to exceed three years. Compensation expense related to stock options is recognized over the requisite service period. The requisite service period for stock options is the same as the vesting period, with the exception of retirement eligible employees, who have shorter requisite service periods ending when the employees become retirement eligible.

Restricted, performance and phantom stock awards granted under the 2007 LTIP typically become 100% vested on the three-year anniversary of the grant date. The fair value of the awards granted is measured based on the fair value of the shares on the date of grant. Related compensation expense is recognized over the requisite service period which is the same as the vesting period.

At the time of the Spectra Energy spin-off from Duke Energy, Duke Energy converted stock options, restricted stock awards, performance awards and phantom stock awards (collectively, Stock-Based Awards) of Duke Energy common stock held by Spectra Energy employees and Duke Energy employees. One replacement Duke Energy Stock-Based Award and one-half Spectra Energy Stock-Based Award were distributed to each holder of Duke Energy Stock-Based Awards for each award held at the time of the spin-off. The Spectra Energy Stock-Based Awards resulting from the conversion are considered to have been issued under the 2007 LTIP.

Spectra Energy allocated pre-tax stock-based compensation expense included in continuing operations to Union Gas for 2010 and 2009 as follows, the components of which are further described below:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Phantom Stock | **1** | 1 |
| Performance Awards | **1** | 1 |
| Total | **2** | 2 |

**Stock Options**

| | **Shares** | **Weighted-Average Exercise Price US$** |
|---|---|---|
| Outstanding at beginning of year | **251,975** | **$25** |
| Transfers in/(out) | **(22,474)** | **24** |
| Granted | **–** | |
| Exercised | **(9,062)** | **18** |
| Forfeited | **(18,681)** | **31** |
| Outstanding at end of year | **201,758** | **$25** |
| Options exercisable at year-end | **201,758** | **$25** |

| | **Options Outstanding** | | | **Options Exercisable** | |
|---|---|---|---|---|---|
| Exercise Prices US$ | Number Outstanding At 12/31/10 | Weighted-Average Remaining Contractual Life(in years) | Weighted-Average Exercise Price US$ | Number Exercisable At 12/31/10 | Weighted-Average Exercise Price US$ |
| $11 – 15 | 21,050 | 2.2 | $12 | 21,050 | $12 |
| $16 – 20 | – | – | – | – | – |
| $21 – 25 | 146,657 | 5.9 | 26 | 146,657 | 26 |
| $26 – 30 | 12,351 | 1.1 | 29 | 12,351 | 29 |
| $31 – 37 | 21,700 | 1.1 | 33 | 21,700 | 33 |
| > $37 | – | – | – | – | – |
| Total | 201,758 | 4.7 | $25 | 201,758 | $25 |

The Company did not award non-qualified stock options to employees during 2010 or 2009. Under the terms of the 2007 LTIP, the exercise price of a non-qualified stock option shall not be less than 100% of the fair market value of Spectra Energy common stock on the date of grant, and the maximum option term is ten years. Spectra Energy issues new shares upon exercising or vesting of share-based awards. The Black-Scholes option-pricing model is used to estimate the fair value of options at grant date. The risk-free rate of return is determined based on a yield curve of U.S. Treasury rates ranging from six months to ten years and a period commensurate with the expected life of the options granted. The expected volatility is established based on historical volatility and implied volatility of a group of 19 peer company stock prices. The expected dividend yield is determined based on Spectra Energy's annual dividend amount as a percentage of the average stock price at the time of grant.

**Performance Awards**

Under the 2007 LTIP, the Company can also grant performance awards. Stock-based performance awards generally vest over three years at the earliest, if performance metrics are met. The Company granted 59,400 performance awards (fair value of US $2 million) during 2010 and 67,600 performance awards (fair value of US $1 million) during 2009.

The unvested and outstanding performance awards granted contain market conditions based on the total shareholder return (TSR) of Spectra Energy common stock relative to a pre-defined peer group. These awards are valued using the Monte Carlo valuation method.

**Weighted-Average Assumptions for Market Based Awards**

| | December 31 2010 | December 31 2009 |
|---|---|---|
| Risk free interest rate | **1.4%** | **1.4%** |
| Expected life (years) | **3** | **3** |
| Expected volatility Spectra Energy | **37.9%** | **41.2%** |
| Expected volatility Peer Group | **22.3-58.5%** | **20.8-53.1%** |
| Market Index | **30.3%** | **28.5%** |
| Expected dividend yield | **–** | **–** |

The risk-free rate of return was determined based on a yield of three year U.S. Treasury bonds on the grant date. The expected volatility was established based on historical volatility over three years using daily stock price observations. A shorter period was used if three years of data was not available. Because the award payout includes dividend equivalents, no dividend yield assumption is required.

The total fair value of the performance shares vested was $333,746 in 2009, $333,522 in 2008. No performance shares vested in 2010. As of December 31, 2010, the Company expects to recognize $2 million of future compensation cost related to stock awards over a weighted-average period of less than two years.

**Phantom Stock Awards**

Stock-based phantom awards granted under the 2007 LTIP generally vest over three years. The Company awarded 65,600 phantom awards (fair value $1 million) during 2010, and 47,600 phantom awards (fair value of $1 million) during 2009.

The total fair value of the phantom shares vested was $778,935 in 2010 and $111,258 in 2009.

## 11. Capital Management

The Company's objectives in managing its capital include the continuation of its ability to serve customers and to generate the OEB allowed rate of return for its shareholders while maintaining the OEB-approved level of common equity.

In managing capital, management considers both debt and equity. The mix of debt and equity components is driven by prevailing market conditions, as the Company may take advantage of lower interest rates by issuing debt or utilizing available credit facilities. The Company is required by Undertakings to the Lieutenant Governor in Council of Ontario to maintain sufficient common equity at the level approved by the OEB. The quarterly dividend payment is determined to allow the Company to maintain the common equity component at the level approved by the OEB.

Various debt covenants require the Company's Indebtedness[14] not to exceed 75% of Total Capitalization[15].

As at December 31, 2010 and 2009, the Company was in compliance with the following externally imposed capital requirements. The Company monitors these requirements on a quarterly basis.

| | **December 31 2010** | December 31 2009 |
|---|---|---|
| OEB-approved minimum Common Equity | **36.00%** | 36.00% |
| Allowed Return on Equity – regulated operations | **8.54%** | 8.54% |
| Maximum Total Indebtedness to Total Capitalization | **75.00%** | 75.00% |
| Actual Total Indebtedness to Total Capitalization | **64.10%** | 61.00% |

## 12. Financial Instruments

Under Canadian GAAP, financial instruments are classified into one of the following five categories: held-for trading, held to maturity investments, loans and receivables, available-for-sale financial assets and other financial liabilities. The carrying value of the Company's financial instruments are classified into the following categories:

| **Classification** *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Financial assets held for trading[16] | **12** | 34 |
| Loans and receivables[17] | **301** | 269 |
| Other financial liabilities[18] | **2,793** | 2,471 |

The fair values of the Company's financial instruments are not materially different from their carrying value, with the exception of the Company's long-term debt of $2,240 million (2009 – $2,212 million). Based on current interest rates for debt with similar terms and maturities, the fair market value is estimated to be $2,610 million (2009 – $2,484 million).

[14] Indebtedness includes short-term borrowings, commercial paper, long-term debt, mandatorily redeemable preference shares and letters of credit.
[15] Capitalization includes shareholders-equity, non-controlling interest and indebtedness.
[16] Includes cash and cash equivalents
[17] Includes accounts receivable
[18] Includes accounts payable and accrued charges, short-term borrowings, long-term debt, and mandatorily redeemable preference shares

*Fair value hierarchy*

Financial instruments recorded at fair value on the Consolidated Balance Sheet are valued using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices);

Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

Cash and cash equivalents are the only financial instruments recorded at fair value on the Consolidated Balance Sheet and are classified as level 1.

*Interest rate risk*

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The long-term debt bears interest at fixed rates and therefore the cash flow exposure is not significant. However, the fair value of loans having fixed rates of interest could fluctuate because of changes in market interest rates. The fair value of short-term borrowings have a limited exposure to interest rate risk due to their short-term maturity.

*Credit risk*

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation. The maximum exposure to credit risk of the Company at period end is the carrying value of its financial assets. The Company’s principal customers for natural gas transportation and storage services are industrial end-users, marketers, local distribution companies and utilities. The Company’s distribution customers are primarily industrial and residential end-users. These concentrations of customers may affect the Company’s overall credit risk.

The Company, in the normal course of its operations, provides gas loans to other parties from its holdings of gas in storage. The replacement amount of gas loans at December 31, 2010 is $72 million receivable (2009 - $39 million receivable). The Company manages its credit exposure related to gas loans by subjecting these parties to the same credit policies it uses for all customers, and obtaining collateral when appropriate.

The Company manages its credit risk on cash and cash equivalents by dealing solely with reputable banks and financial institutions. To manage its credit risk on accounts receivable, the Company performs ongoing credit reviews of all its customers. In cases where the credit quality of a customer does not meet the Company’s requirements, a cash deposit, letter of credit or parental guarantee is required. Deposits held by the Company at December 31, 2010 amounted to $51 million (2009 - $58 million). Significant financial difficulties of the debtor, the probability that the debtor will enter bankruptcy or financial reorganization, and default or delinquency in payments are considered indicators that the account receivable may be uncollectible and therefore should be included in the allowance for doubtful accounts.

Union Gas continues to utilize its established risk management policies and procedures to ensure the appropriate monitoring of customer credit positions and, based on current evaluations, does not expect any significant negative impacts associated with these positions.

The following table sets forth details of the age of trade receivables that are not impaired as well as the allowance for the doubtful accounts:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Current | **282** | 242 |
| 30 Days over due | **9** | 9 |
| 60 Days over due | **3** | 3 |
| 90+ Days over due | **6** | 10 |
| Total trade accounts receivable | **300** | 264 |
| Allowance for doubtful accounts | **(5)** | (6) |
| Total trade accounts receivable, net[19] | **295** | 258 |

For the years ended December 31, 2010 and 2009, no one customer accounted for more than 10% of sales or 10% of receivables.

*Equity Price Risk*

Our costs of providing non-contributory defined benefit retirement and postretirement benefit plans are dependent upon, among other things, rates of return on plan assets. These plan assets expose us to price fluctuations in equity markets. In addition, our captive insurance company maintains various investments to fund certain business risks and losses. Those investments may, from time to time, include investments in equity securities. Currently, we do not invest in equity securities other than employee benefits plan assets.

*Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its obligations as they become due. The Company manages its liquidity risk by forecasting cash flows from operations and anticipated investing and financing activities. The Company has credit facilities available to help meet short-term financing needs (note 6).

The following are the contractual maturities of the undiscounted cash flows of financial liabilities as at December 31, 2010:

| *($millions)* | Total | Less than 1 year | 2 – 3 years | 4 – 5 years | More than 5 years |
|---|---|---|---|---|---|
| Short-term borrowings | 198 | 198 | – | – | – |
| Commercial paper | 157 | 157 | – | – | – |
| Accounts payable and accrued charges | 582 | 582 | – | – | – |
| Long-term debt (including principal and interest) | 4,123 | 402 | 271 | 560 | 2,890 |
| Mandatorily redeemable preference shares | 5 | – | – | – | 5 |
| Total | 5,065 | 1,339 | 271 | 560 | 2,895 |

[19] The carrying amount of accounts receivable is impacted by changes in gas prices, which may fluctuate significantly from year to year.

## 13. Employee Future Benefits

The Company sponsors five defined benefit registered pension plans and one registered pension plan with both a defined benefit provision and a defined contribution provision. Our eligible employees participate in one of these registered pension plans. All of the defined benefit plans provide a final average earnings related benefit. The Company makes contributions to the defined contribution plan based on the salary, age and service of each member. Supplemental defined benefit pensions are provided to all employees affected by the maximum pension limits under the Income Tax Act. Other post-retirement benefits provided include health and dental benefits, life insurance coverage and a health care spending account.

Accrued benefit obligations are determined using the projected benefit method pro-rated on services. The Company uses a measurement date of September 30. In determining the accrued benefit obligations and current service costs, the Company uses Management's best-estimate assumptions, except for the liability discount rate, which is determined as the yield on high quality fixed income investments with a term to maturity similar to the covered benefits.

Plan assets are valued at fair value. The calculation of the expected return on assets is based on a market related value of assets, with the market related adjustment determined over a three-year period.

The transitional obligation associated with the change in accounting for Employee Future Benefits at January 1, 2000 is being amortized on a straight line basis over the expected average remaining service lifetime (EARSL) of employees active at January 1, 2000. Past service costs arising from plan amendments are amortized on a straight-line basis over the EARSL of employees active at the date of the amendment. The amount by which the net unamortized cumulative actuarial gain or loss based on the market related value of assets exceeds 10% of the greater of the accrued benefit obligation and the market related value of assets at the beginning of the period is amortized on a straight-line basis over the EARSL of employees active at the beginning of the period. The average remaining service period of the active employees covered by the retirement plans is 10 years. The average remaining service period of the active employees eligible for post retirement benefits other than pensions is 18 years.

The Company made the following employee future benefit contributions:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Defined benefit plans | **40** | 41 |
| Defined contribution pension plan | **5** | 4 |
| Supplemental pension | **1** | 1 |
| Other than pensions | **2** | 3 |
| | **48** | 49 |

### Actuarial Valuations

| | **Pension Benefit Plans** | **Post-Retirement Benefits Other Than Pensions** |
|---|---|---|
| Most recent | January 1, 2010 | January 1, 2009 |
| Next scheduled | January 1, 2011 | January 1, 2012 |

**Benefit Obligations, Plan Assets and Funded Status**

| | Years Ended December 31 | | | |
|---|---|---|---|---|
| | Pension | | Other | |
| *($millions)* | **2010** | 2009 | **2010** | 2009 |
| **Change in benefit obligations** | | | | |
| Balance, beginning of year | **585** | 529 | **60** | 49 |
| Employer current service cost | **11** | 9 | **2** | 1 |
| Member contributions | **3** | 3 | **–** | – |
| Interest cost | **34** | 31 | **3** | 3 |
| Benefits paid | **(30)** | (27) | **(2)** | (3) |
| Past service cost | **7** | – | **–** | – |
| Actuarial loss | **45** | 40 | **6** | 10 |
| Balance, end of year | **655** | 585 | **69** | 60 |
| **Change in fair value of assets** | | | | |
| Fair value, beginning of year | **443** | 418 | **–** | – |
| Actual return on plan assets | **45** | 6 | **–** | – |
| Employer contributions | **42** | 43 | **2** | 3 |
| Member contributions | **3** | 3 | **–** | – |
| Benefits paid | **(30)** | (27) | **(2)** | (3) |
| Fair value, end of year | **503** | 443 | **–** | – |
| **Funded status** | | | | |
| Net funded status | **(152)** | (142) | **(69)** | (60) |
| Unamortized net actuarial loss | **258** | 238 | **17** | 11 |
| Unamortized past service costs | **12** | 7 | **–** | – |
| Unamortized transitional obligation | **6** | 7 | **8** | 9 |
| Contributions remitted after measurement date | **10** | 11 | **–** | 1 |
| Accrued benefit asset (liability), end of year | **134** | 121 | **(44)** | (39) |
| **Classification of accrued benefit assets (liabilities)** | | | | |
| Regulatory and other assets | **152** | 137 | **–** | – |
| Regulatory and other liabilities | **(18)** | (16) | **(44)** | (39) |
| Accrued benefit asset (liability) | **134** | 121 | **(44)** | (39) |
| **Allocation of assets to major classes** | | | | |
| Equity securities | **54%** | 60% | **–** | – |
| Debt securities | **46%** | 40% | **–** | – |

For 2010 and 2009, all of the defined benefit pension plans had accrued benefit obligations that exceeded the fair value of plan assets. The other post-retirement benefit plans are not pre-funded.

**Net benefit cost**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | **Pension** | | **Other** | |
| *($millions)* | **2010** | 2009 | **2010** | 2009 |
| Current service cost | **11** | 9 | **2** | 1 |
| Interest cost | **34** | 31 | **3** | 3 |
| Actual return on plan assets | **(45)** | (6) | **–** | – |
| Actuarial losses | **45** | 40 | **6** | 10 |
| Past service cost | **7** | – | **–** | – |
| Elements of employee future benefits costs before adjustments to recognize the long-term nature of employee future benefit costs | **52** | 74 | **11** | 14 |
| Adjustments to recognize the long-term nature of employee future benefit costs: | | | | |
| Difference between actual and expected return | **11** | (27) | **–** | – |
| Difference between actual and recognized actuarial gains in year | **(31)** | (34) | **(6)** | (10) |
| Difference between actual and recognized past service costs in year | **(5)** | 1 | **–** | – |
| Amortization of transitional obligation | **1** | 2 | **2** | 2 |
| Defined benefit costs recognized | **28** | 16 | **7** | 6 |
| Defined contribution cost | **5** | 4 | **–** | – |
| Total net benefit cost | **33** | 20 | **7** | 6 |

**Weighted average assumptions used to determine benefit liability**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | **Pension** | | **Other** | |
| | **2010** | 2009 | **2010** | 2009 |
| Discount rate at measurement date | **5.04%** | 5.62% | **5.11%** | 5.69% |
| Rate of compensation increase | **3.25%** | 3.50% | **3.25%** | 3.50% |
| Initial overall health care trend rate | **–** | – | **8.00%** | 8.00% |
| Annual rate of decline in health care trend rate | **–** | – | **0.50%** | 0.50% |
| Ultimate health care cost trend rate | **–** | – | **5.00%** | 5.00% |
| Year that the rate reaches the ultimate trend rate | **–** | – | **2017** | 2016 |

**Weighted average assumptions used to determine net benefit cost**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | Pension | | Other | |
| | **2010** | 2009 | **2010** | 2009 |
| Discount rate | **5.62%** | 5.98% | **5.69%** | 6.03% |
| Expected rate of return on plan assets | **7.00%** | 7.00% | **–** | – |
| Rate of compensation increases | **3.50%** | 3.50% | **3.50%** | 3.50% |
| Initial overall health care trend rate | **–** | – | **8.00%** | 8.00% |
| Annual rate of decline in health care trend rate | **–** | – | **0.50%** | 0.50% |
| Ultimate health care cost trend rate | **–** | – | **5.00%** | 5.00% |
| Year that the rate reaches the ultimate trend rate | **–** | – | **2016** | 2015 |

**Sensitivity of key assumption**

| *($millions)* | Post-Retirement Benefits Other than Pensions | |
|---|---|---|
| Assumed change in health care cost trend rate | **1% Increase** | **1% Decrease** |
| Change in obligation | **6** | (6) |

### 14. Income Taxes

The provision for income taxes consists of the following:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Current | **16** | 103 |
| Future | **25** | (55) |
| | **41** | 48 |

The year-over-year change in the components of current and future income taxes is primarily due to the difference in the treatment of the approved cost and the actual cost of gas for income tax and accounting purposes.

Net income taxes paid in 2010 were $96 million (2009 - $47 million).

Reconciliation between the combined Federal and Ontario statutory tax rate and the effective rate of income taxes is as follows:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Income before income taxes | **247** | 223 |
| Statutory income tax rate (percent) | **31.0** | 33.0 |
| Statutory income tax rate applied to accounting income | **77** | 74 |
| Increase/(decrease) resulting from: | | |
| Future tax recovery resulting from tax rate changes | **(4)** | (44) |
| Future regulatory income tax payable/receivable recorded through tax expense | **(32)** | 18 |
| Provision for income taxes | **41** | 48 |
| Effective rate of income tax (percent) | **16.6** | 21.0 |

The future income taxes recorded in current assets of $14 million (2009 – $57 million) arise from temporary differences primarily related to regulatory deferral accounts.

The long-term future income tax liability of $361 million (2009 - $327 million) includes the following:

| *($millions)* | **December 31 2010** | December 31 2009 |
|---|---|---|
| Temporary differences related to pension asset | **26** | 26 |
| Temporary differences related to accelerated depreciation rates | **335** | 301 |
| | **361** | 327 |

### 15. Related Party Transactions

The Company purchases gas, storage and transportation services at prevailing market prices and under normal trade terms from related parties. During the year ended December 31, 2010, these purchases totalled $11 million (2009 – $6 million). Union Gas also provides storage and transportation services to related parties which totalled $1 million during 2010 (2009 – $1 million).

The Company provided administrative, management and other services to related parties totalling $10 million (2009 – $9 million), which were billed and recovered at cost. Charges from related parties for administrative and other goods and services were $9 million (2009 – $7 million).

At December 31, 2010 the Company had receivable balances of $2 million (2009 – $6 million) and payable balances of $3 million (2009 – $6 million) with related parties, all of which are recorded in accounts receivable and accounts payable, respectively.

During 2010, the Company obtained from and provided unsecured loans to Westcoast. The balance outstanding on these loans at December 31, 2010 was a $198 million payable (2009 – $6 million receivable). These loans are classified as short-term borrowings in 2010. Interest received on these loans during 2010 totalled less than $1 million (2009 – less than $1 million) and interest paid on these loans totalled less than $1 million (2009 – less than $1 million). Interest on these loans is calculated based on the monthly average of 30-day banker's acceptance rates.

### 16. Contingencies

The Company, in the course of its operations, is subject to environmental and other claims, lawsuits and contingencies. Accruals are made in instances where it is probable that liabilities will be incurred and where such liabilities can be reasonably estimated. The Company has no reason to believe that the ultimate outcome of these matters could have a significant impact on its consolidated financial statements.

## DIRECTORS

**David G. Unruh**

**Julie A. Dill**

**Bruce E. Pydee**

## OFFICERS

**Julie A. Dill**
Chair and President

**J. Patrick Reddy**
Chief Financial Officer

**M. Richard Birmingham**
Vice President, Regulatory, Government, Aboriginal and Public Affairs

**Bruce E. Pydee**
Vice President and General Counsel

**Bohdan I. Bodnar**
Vice President, Human Resources

**Menelaos Ydreos**
Vice President, Marketing and Customer Care

**Allen C. Capps**
Vice President, Business Development – Storage and Transmission

**Paul Rietdyk**
Vice President, Distribution Operations

**Michael P. Shannon**
Vice President, Engineering, Construction and Storage and Transmission Operations

**Joe R. Martucci**
Vice President, Finance

**Stephen W. Baker**
Vice President and Treasurer

**Timothy Kennedy**
Vice President, Federal Government Affairs

**Paul K. Haralson**
Assistant Treasurer

**Patricia M. Rice**
Corporate Secretary

**Leigh A. Hodgins**
Assistant Secretary

**Joseph Marra**
Assistant Secretary

## CORPORATE INFORMATION

Transfer Agent and Registrar **CIBC Mellon**

Union Gas Limited preference shares are listed on the Toronto Stock Exchange
**Class A Preference, Series A – 5½% (UNG.PR.C)**

**Class A Preference, Series B – 6% (UNG.PR.D)**

## REGISTERED OFFICE

50 Keil Drive North Chatham, Ontario N7M 5M1

# AUDITORS' REPORT

To the Shareholders of
Union Gas Limited

We have audited the balance sheets of Union Gas Limited as at December 31, 2000 and 1999 and the statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2000 and 1999 and the results of its operations and cash flows for the years then ended in accordance with accounting principles generally accepted in Canada.

Toronto, Ontario
January 26, 2001

Ernst & Young LLP
Chartered Accountants

**UNION GAS LIMITED**
**Statements of Income**

| *For the Years Ended December 31 ($millions)* | **2000** | 1999 |
|---|---|---|
| Gas sales | **1,038** | 992 |
| Cost of gas (note 16) | **796** | 708 |
| Gas sales margin | **242** | 284 |
| Transportation service (note 16) | **363** | 285 |
| Gas distribution margin | **605** | 569 |
| Transportation and storage revenue | **180** | 158 |
| Other revenue | **33** | 35 |
| | **818** | 762 |
| Expenses | | |
| Operating and maintenance (note 16) | **271** | 264 |
| Depreciation and amortization (note 5) | **148** | 141 |
| Property and capital taxes | **54** | 54 |
| | **473** | 459 |
| Operating income | **345** | 303 |
| Interest expense | | |
| Long-term debt | **161** | 158 |
| Short-term debt | **16** | 13 |
| Interest capitalized | **(2)** | (3) |
| | **175** | 168 |
| Income before income taxes | **170** | 135 |
| Income taxes (notes 2, 3 and 14) | **57** | 40 |
| **Net income** | **113** | 95 |
| Preference share dividend requirement | **5** | 5 |
| Earnings applicable to common shares | **108** | 90 |

*(See accompanying notes)*

**UNION GAS LIMITED**
**Statements of Retained Earnings**

| *For the Years Ended December 31 ($millions)* | **2000** | 1999 |
|---|---|---|
| Retained earnings, beginning of year | **353** | 513 |
| Net income | **113** | 95 |
| Dividends | | |
| Preference shares | **5** | 5 |
| Common shares | **65** | 212 |
| Distribution of equity on assets sold (note 15) | **-** | 38 |
| Retained earnings, end of year | **396** | 353 |

*(See accompanying notes)*

**UNION GAS LIMITED**
**Balance Sheets**

| *As at December 31 ($millions)* | **2000** | 1999 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Accounts receivable (note 16) | **347** | 263 |
| Inventories (note 4) | **398** | 315 |
| Income taxes receivable | **-** | 14 |
| Deferred income taxes (notes 3 and 16) | **49** | 22 |
| | **794** | 614 |
| Property, plant and equipment (note 5) | **3,003** | 2,947 |
| Investments and other assets (note 6) | **201** | 209 |
| | **3,998** | 3,770 |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities | | |
| Short-term borrowings (note 7) | **509** | 455 |
| Accounts payable and accrued charges (note 16) | **306** | 287 |
| Income and other taxes payable | **26** | - |
| Long-term debt due within one year (note 8) | **11** | 47 |
| | **852** | 789 |
| Long-term debt (note 8) | **1,694** | 1,595 |
| Redeemable preference shares (note 9) | **5** | 5 |
| Deferred income taxes (notes 2 and 3) | **301** | 319 |
| Shareholders' equity | | |
| Share capital (note 10) | **750** | 709 |
| Retained earnings | **396** | 353 |
| | **1,146** | 1,062 |
| | **3,998** | 3,770 |

Contingencies (notes 11 and 17)
*(See accompanying notes)*

Approved by the Board

Adrian Ryans
Director

Robert T. Reid
Director

**UNION GAS LIMITED**
**Statements of Cash Flows**

| *For the Years Ended December 31 ($millions)* | **2000** | 1999 |
|---|---|---|
| **Operating Activities** | | |
| Net income | **113** | 95 |
| Charges not affecting cash | | |
| Depreciation and amortization | **150** | 143 |
| Deferred income taxes | **(26)** | (17) |
| Operating cash flow | **237** | 221 |
| Non-cash working capital changes | | |
| Accounts receivable | **(84)** | (13) |
| Gas in storage | **(84)** | (69) |
| Accounts payable and accrued charges and other | **57** | 16 |
| | **126** | 155 |
| **Investing Activities** | | |
| Additions to property, plant and equipment | **(204)** | (222) |
| Decrease in investments and other assets | **8** | 1 |
| Proceeds on sale of assets (note 15) | **-** | 342 |
| | **(196)** | 121 |
| **Financing Activities** | | |
| Increase (decrease) in short-term borrowings | **54** | (47) |
| Long-term debt | | |
| Issued | **185** | - |
| Retired | **(122)** | (12) |
| Common shares issued | **23** | - |
| Dividends | **(70)** | (217) |
| | **70** | (276) |
| Change in cash during the year and cash, end of year | **-** | - |

*(See accompanying notes)*

**UNION GAS LIMITED**
**Notes to Financial Statements**
**December 31, 2000**

## 1. Significant Accounting Policies

### Accounting Principles

The financial statements have been prepared in accordance with accounting principles generally accepted in Canada. The preparation of financial statements in conformity with accounting principles generally accepted in Canada requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities.

### Regulation

The utility operations are subject to regulation under the Ontario Energy Board Act and the Energy Act (Ontario). Rate schedules are approved periodically by the Ontario Energy Board (OEB) and are designed to permit a fair and reasonable return on the utility investment after recovering the utility cost of service. Realization of the allowed rate of return is subject to actual operating conditions experienced during the year.

The Company has filed an application with the OEB for an order approving rates for the year 2000 and thereafter in accordance with a performance based regulation mechanism. The application also sought an order from the OEB approving the unbundling of certain rates charged for the sale, distribution, transportation and storage of natural gas. The hearing for this application concluded in August 2000, but a decision has not yet been rendered by the OEB. Revenue in 2000 includes an assumption for cost pass-through and other items based upon previous regulatory practice. The full impact of the decision, which is not certain, will be accounted for at the date of the regulatory decision.

The Company operates within southwestern, northern and eastern Ontario under franchise agreements with individual municipalities that are approved by the OEB.

### Gas Sales and Cost of Gas

Gas sales revenue is recorded on the basis of regular meter readings and estimates of customer usage since the last meter reading date to the end of the reporting period. Cost of gas is recorded using prices approved by the OEB in the determination of customer sales rates. Differences between the OEB approved reference prices and those costs actually incurred are deferred for future disposition subject to approval by the OEB.

In the matching of gas sales revenue and cost of gas sold, volumetric differences arise from the measurement process. The Company includes in the cost of gas an estimated amount of these volumetric differences based upon the methodology recognized by the OEB in the determination of customer sales rates. Annual fluctuations from the estimated level are deferred and amortized over a period of three years.

### Income Taxes

Effective January 1, 2000, The Canadian Institute of Chartered Accountants (CICA) changed the accounting standards relating to the accounting for income taxes to the liability method. The CICA's new standard continues to allow the Company to account for income taxes using the flow through tax accounting methodology as approved by the OEB. Under flow through tax accounting, income tax expense is recorded on the basis of income taxes currently payable. Rates and revenues for utility operations include recovery of only such income taxes as are currently payable. Accordingly, the Company does not provide for income taxes deferred to future years as a result of dfferences in the treatment for income tax and accounting purposes of various items of income and expenditure. The only exception is that the Company calculates deferred income taxes on temporary differences between the approved cost and the actual cost of gas and other amounts deferred in accounts approved by the OEB.

Prior to 1997, the Company utilized the tax allocation method to account for income taxes. Under this method, provision was made for income taxes deferred principally as a result of claiming capital cost allowance for income tax purposes in excess of depreciation provided in the accounts. Note 2 describes the method for disposition of the accumulated deferred tax balance.

In the event that the Company had implemented the liability method for fiscal 2000, the deferred income tax liabilities and assets and deferred income tax expense would have been:

| ($millions) | Liability Method | | Flow Through Method | |
|---|---|---|---|---|
| | **2000** | 1999 | **2000** | 1999 |
| Current deferred income tax asset | **49** | 22 | **49** | 22 |
| Long term deferred income tax liability | **419** | 449 | **301** | 319 |
| Deferred income tax expense (recovery) | **(39)** | 7 | **(26)** | (16) |

### Inventories

Gas in storage is carried at prices approved by the OEB in the determination of customer sales rates. Inventories of materials and supplies are valued at the lower of average cost, replacement cost and net realizable value.

### Property, Plant and Equipment and Depreciation

Property, plant and equipment are carried at cost which includes all direct costs, overhead attributable to construction and interest capitalized during construction. The cost of property, plant and equipment is reduced by contributions and grants in aid of construction received from customers and governmental bodies in support of specific transmission and distribution facilities.

The original cost of depreciable units retired, together with the net cost of removal less salvage, is charged to accumulated depreciation. Under this method, no income or loss is recognized on ordinary retirements of depreciable property.

Depreciation is provided on the straight-line method at various rates based on the average service life of each class of property, ranging from 4 to 60 years. Depreciation rates are determined by periodic review and approved by the OEB.

### Employee Benefit Plans

Effective January 1, 2000, the Company adopted, on a prospective basis, the new recommendations of the CICA with respect to accounting for employee future benefits. The new recommendations modify the previous CICA requirements for pension costs and obligations and apply the modified requirements to non-pension benefits. Under the new recommendations, the Company will replace the pay-as-you-go method of accounting for post-retirement benefits other than pensions with accrual accounting that recognizes the liability and expense in the period when the benefits are earned, not received. The effect of adopting the new recommendations was to decrease 2000 pre-tax income by approximately $7 million.

Under the new recommendations, the Company accrues its obligations under employee benefit plans and the related costs, net of plan assets. The plan assets are valued at fair value. Past service costs from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. The average remaining service period of the active employees covered by both the pension plans and the other retirement benefits plans is 17 years.

For defined contribution plans maintained by the Company, contributions payable by the Company are expensed as pension costs.

### Natural Gas Swap and Other Contracts

The Company's gas supply portfolio includes contracts with pricing mechanisms that reflect monthly variations in the price of gas, rather than fixed prices. In order to manage price volatility, hedges are used to fix gas prices with respect to the underlying physical gas supply contracts. The hedges include the use of natural gas swaps and purchase price collars. The actual cost of gas purchased includes the impact of any hedging activities related to these contracts. The Company negotiates natural gas swap and purchase price collar contracts only with those institutions that have a credit rating of A or higher.

## 2. Deferred Income Taxes

In 1997, following approval by the OEB, the Company changed its accounting for income taxes related to utility operations from the tax allocation method to flow through tax accounting consistent with the determination of 1997 rates. This change was applied prospectively since the basis for determining the Company's rates and revenues for utility operations were previously established taking into account the provision for income taxes based on the tax allocation methodology.

The deferred tax balance of $301 million at December 31, 2000 (1999 - $319 million) includes $293 million (1999 - $308 million) that arose from using the tax allocation methodology related to utility operations. As approved by the OEB, this balance is reduced as the timing differences that gave rise to these deferred income taxes reverse. The timing differences related to utility operations are expected to reverse over approximately 18 years.

## 3. Income Tax Treatment of Gas Cost and Other OEB Approved Deferral Accounts

The Company has recorded an amount of $74 million payable (1999 - $52 million payable) that represents gas costs and other amounts deferred in accounts approved by the OEB.

The Company is required to deduct from or include in taxable income the actual amounts incurred related to these deferral accounts. The change in the deferral account balances during the year resulted in an increase in taxable income of $22 million (1999 - $20 million). The Company recorded deferred income taxes of $9 million (1999 - $9 million) with respect to these amounts.

## 4. Inventories

| *($millions)* | **2000** | 1999 |
|---|---|---|
| Gas in storage | **371** | 287 |
| Materials and supplies | **27** | 28 |
| | **398** | 315 |

## 5. Property, Plant and Equipment

| *($millions)* | **2000** | 1999 |
|---|---|---|
| Cost | | |
| Distribution | **2,478** | 2,377 |
| Transmission | **999** | 982 |
| Storage | **553** | 513 |
| General | **256** | 261 |
| | **4,286** | 4,133 |
| Accumulated depreciation | | |
| Distribution | **764** | 701 |
| Transmission | **299** | 274 |
| Storage | **125** | 111 |
| General | **95** | 100 |
| | **1,283** | 1,186 |
| Net book value | **3,003** | 2,947 |

Gas distribution plant is net of contributions in aid of construction of $153 million (1999-$147 million). Depreciation rates used during the year ended December 31, 2000 resulted in a composite rate of 3.56% (1999-3.38%). In 2000, $2 million (1999-$2 million) of depreciation was allocated to operating and maintenance expense rather than to depreciation and amortization expense shown on the Statements of Income.

Property, plant and equipment includes assets that are not subject to depreciation totalling $111 million (1999-$106 million). These assets include land, base pressure gas in storage reservoirs and assets under construction.

## 6. Investments and Other Assets

| *($millions)* | **2000** | 1999 |
|---|---|---|
| Centra Gas Manitoba Inc. 10.625% debentures net of current portion of $1 million (1999 - $1 million) | **10** | 10 |
| UEI Holdings Inc. 5.2% cumulative redeemable preferred shares (note 15) | **150** | 150 |
| Deferred charges and other | **41** | 49 |
| | **201** | 209 |

## 7. Short-term Borrowings

The Company has total bank lines of credit of $600 million. The lines of credit include a committed credit facility of $550 million with a one-year term that commenced in July 2000, and a $50 million operating facility. During the term of the committed credit facility, the Company has the option to convert drawings under the facility to loans not exceeding eighteen months. The bank lines of credit are unsecured.

These lines of credit enable the Company to borrow directly from banks, issue banker's acceptances and support a commercial paper program. Most of the short-term cash requirements are funded through issuing commercial paper at rates generally below prime. The average interest rate on short-term borrowings for the year ended December 31, 2000 was 5.7% (1999 – 5.2%).

Total short-term interest paid in 2000 was $11 million (1999 - $14 million).

## 8. Long-term Debt

| *($millions)* | **2000** | 1999 |
|---|---|---|
| Sinking fund debentures | | |
| 13.375% 1980 Series debentures, due March 31, 2000 | **-** | 36 |
| 11.55% 1988 Series II debentures, due October 15, 2010 | **73** | 77 |
| 13.5% senior debentures due November 14, 2008 | **10** | 11 |
| 10.625% senior debentures due July 14, 2006 | **39** | 42 |
| 10.75% senior debentures due July 31, 2009 | **48** | 51 |
| Other long-term debt | | |
| 10.625% 1986 Series debentures, due December 15, 2005 | **-** | 75 |
| 10.625% 1989 Series debentures, due July 11, 2011 | **125** | 125 |
| 11.5% 1990 Series debentures, due August 28, 2015 | **150** | 150 |
| 9.7% 1992 Series II debentures, due November 6, 2017 | **125** | 125 |
| 8.75% 1993 Series debentures, due August 3, 2018 | **125** | 125 |
| 7.90% 1994 Series debentures, due February 24, 2014 | **150** | 150 |
| 9.75% 1994 Series II debentures, due December 13, 2004 | **125** | 125 |
| 8.65% 1995 Series debentures, due November 10, 2025 | **125** | 125 |
| 9.7% senior debentures, due December 9, 2002 | **75** | 75 |
| 8.65% senior debentures, due October 19, 2018 | **75** | 75 |
| 8.85% senior debentures, due September 1, 2005 | **100** | 100 |
| 7.8% senior debentures, due December 1, 2006 | **75** | 75 |
| Medium-term note debentures | | |
| 5.7% Series 1, due July 14, 2008 | **100** | 100 |
| 7.2% Series 2, due June 1, 2010 | **185** | - |
| | **1,705** | 1,642 |
| Less: current portion | **11** | 47 |
| | **1,694** | 1,595 |

The weighted average cost of long-term debt for the year ended December 31, 2000 was 9.2% (1999 - 9.4%). Principal repayment requirements on long-term debt are as follows:

| *($ millions)* | | |
|---|---|---|
| 2001 | - | 11 |
| 2002 | - | 86 |
| 2003 | - | 11 |
| 2004 | - | 136 |
| 2005 | - | 111 |
| Thereafter | - | 1,350 |
| Total | | 1,705 |

Under the terms of the trust indentures relating to certain debentures, the Company has agreed to limit the payment of dividends and to meet certain interest coverage ratios prior to the issue of additional long-term debt. The Company is in compliance with all such covenants.

Total interest paid on long-term debt in 2000 was $160 million (1999 - $157 million).

## 9. Redeemable Preference Shares

| *($ millions)* | | **2000** | 1999 |
|---|---|---|---|
| **Authorized** | **Issued** | | |
| Preference shares | | | |
| Class A – 103,972 shares (1999 – 105,172) | 54,472 Series A, 5.5% (1999 – 55,672) | **3** | 3 |
| | 49,500 Series C, 5% (1999 – 49,500) | **2** | 2 |
| Class B - unlimited shares | Nil | **-** | - |
| | | **5** | 5 |
| Less: current portion | | **-** | - |
| | | **5** | 5 |

The Class A Preference Shares, Series A and C are cumulative and redeemable at $50.50 per share. Through the operation of a purchase fund the Company is obligated to offer to purchase $170,000 of Series A and $140,000 of Series C shares annually at the lowest price obtainable but not exceeding $50 per share.

## 10. Share Capital

| *($ millions)* | | **2000** | 1999 |
|---|---|---|---|
| **Authorized** | **Issued** | | |
| Preference shares | | | |
| Class A - 90,000 shares | 90,000 Series B, 6% | **5** | 5 |
| Class B - unlimited shares | 4,000,000 Series 10, 4.88% | **100** | 100 |
| Class C - unlimited shares | 100,000 Series 1 | **18** | - |
| | | **123** | 105 |
| Common shares - unlimited shares | 57,822,650 shares (1999 - 56,758,820) | **627** | 604 |
| | | **750** | 709 |

The Class A Preference Shares, Series B are cumulative and redeemable at $55 per share.

The Class B Preference Shares, Series 10 are cumulative and redeemable at the Company's option and convertible into Class B Preference Shares, Series 11 every five years commencing January 1, 2004. The dividend rate is fixed until December 31, 2003, at which point the dividend will become floating at an annual rate of 80% of the prime rate.

The Class C Preference Shares, Series 1 are cumulative and mandatorily redeemable on a quarterly basis if in that quarter, the Company's corporate tax instalment, which would otherwise have been payable but for the utilization of the Union Energy Inc. (UEI) losses (note 16), is reduced as a result of the use by the Company of the UEI losses. The number of shares redeemed in a quarter is based on the tax instalment reduction realized in the quarter. The proceeds on redemption are payable in either cash or Class C Preference Shares, Series 2. Class C Preference Shares not redeemed by December 31, 2003 will be redeemed without consideration. A quarterly cumulative dividend of 6% per annum of the amount by which the Company's tax instalments have been reduced by the utilization of the UEI losses, will be payable if the Company fails to make quarterly required redemption payments.

### 11. Natural Gas Swap Contracts

The purchase price applicable to approximately 79% of the Company's forecast gas supply from January through October 2001 is indexed to either the New York Mercantile Exchange Natural Gas Futures contracts or the Canadian Gas Price Reporter Alberta border average monthly price. At December 31, 2000, the purchase price applicable to 127 $10^6 m^3$ or 4% of this indexed supply has been effectively fixed through the use of natural gas swap contracts.

### 12. Fair Values of Financial Assets and Liabilities

The following fair value information is provided to comply with financial instrument disclosure requirements. Fair values have been estimated by reference to quoted market prices for the actual or similar instruments where available. The fair value of accounts receivable and current liabilities approximated their carrying amounts in the financial statements due to the relatively short period to maturity of these instruments. The carrying values and fair values (FV) of the Company's other financial instruments are as follows:

| *($millions)* | **2000** | | 1999 | |
|---|---|---|---|---|
| | **Carrying Value** | **FV** | Carrying Value | FV |
| Assets | | | | |
| Centra Gas Manitoba Inc. debentures | **10** | **10** | 10 | 11 |
| UEI Holdings Inc. preferred shares | **150** | **150** | 150 | 150 |
| Natural gas swap contracts | **-** | **32** | - | (6) |
| Liabilities | | | | |
| Long-term debt | **1,705** | **1,754** | 1,642 | 1,761 |
| Redeemable preference shares | **5** | **5** | 5 | 5 |

Under the regulatory process, the Company recovers the weighted average cost of its long-term debt through its cost of service. Accordingly, the Company cautions readers that estimated fair values may not be relevant for their purposes.

## 13. Employee Future Benefits

The Company has defined benefit pension plans, defined contribution pension plans and defined benefit plans providing retirement and post-employment health and life insurance benefits for most employees.

The defined contribution pension expense for the year ended December 31, 2000 was $2 million.

Information about the defined benefit plans, in aggregate, for the year ended December 31, 2000 is as follows:

| *($millions)* | Pension Benefit Plans | Other Benefit Plans |
|---|---|---|
| Accrued benefit obligations | | |
| Balance, beginning of year | **349** | **40** |
| Current service cost | **7** | **1** |
| Interest cost | **24** | **3** |
| Benefits paid | **(26)** | **(2)** |
| Balance, end of year | **354** | **42** |
| Plan assets | | |
| Fair value, beginning of year | **346** | **-** |
| Return on plan assets | **25** | **-** |
| Employer contributions | **10** | **-** |
| Employees' contributions | **2** | **-** |
| Benefits paid | **(26)** | **-** |
| Actuarial gains | **32** | **-** |
| Fair value, end of year | **389** | **-** |
| Funded status – plan surplus (deficit) | **35** | **(42)** |
| Unamortized net actuarial gain | **(32)** | **-** |
| Unamortized transitional obligation | **24** | **37** |
| Accrued benefit asset (liability) | **27** | **(5)** |

The non-pension defined benefit plans are unfunded.

There are also certain defined benefit pension plans that have accrued obligations that exceed their plan assets. For those plans, the accrued benefit obligations are $25 million and the fair value of plan assets are $12 million.

The following is a summary of the weighted average significant actuarial assumptions used in measuring the Company's accrued benefit obligations:

| | Pension Benefit Plans | | Other Benefit Plans |
|---|---|---|---|
| | **2000** | 1999 | **2000** |
| Discount rate | **7.00%** | 7-8% | **7.00%** |
| Expected long-term rate of return on plan assets | **7.50%** | 7-8% | **N/A** |
| Rate of compensation increase | **3.25%** | 3.25-6% | **3.25%** |

In addition, in determining the expected cost of health care benefit plans, it is assumed that the inflationary increase of health care costs will decrease gradually to 5% in 2003 and remain level thereafter.

The Company's net benefit plan expense for the year ended December 31, 2000 is as follows:

| ($millions) | Pension Benefit Plans | Other Benefit Plans |
|---|---|---|
| Current service cost | **5** | **1** |
| Interest on projected benefit obligation | **24** | **3** |
| Return on plan assets | **(25)** | **-** |
| Amortization of transitional obligation | **2** | **2** |
| Net benefit plan expense | **6** | **6** |

## 14. Income Taxes

The provision for income taxes consists of the following:

| *($millions)* | **2000** | 1999 |
|---|---|---|
| Current | **83** | 56 |
| Deferred | **(26)** | (16) |
| | **57** | 40 |

A reconciliation between the combined Federal and Ontario statutory tax rate and the effective rate of income taxes is as follows:

| | **2000** | 1999 |
|---|---|---|
| Income before income taxes | **170** | 135 |
| Statutory income tax rate (percent) | **42.83** | 43.5 |
| Statutory income tax rate applied to accounting income | **73** | 58 |
| Increase (decrease) resulting from: | | |
| Dividend income | **(3)** | (3) |
| Large corporations tax | **8** | 7 |
| Deductions claimed for income tax purposes in excess of amounts recorded for accounting purposes | **(6)** | (10) |
| Amortization of deferred income taxes | **(15)** | (9) |
| Other | **-** | (3) |
| Provision for income taxes | **57** | 40 |
| Effective rate of income taxes (percent) | **33.5** | 29.6 |

Total income taxes paid in 2000 were $48 million (1999 - $31 million).

## 15. Sale of Assets

On January 1, 1999, following the approval of the OEB, the Company sold its net assets relating to the retail merchandise programs to UEI Holdings Inc. (UEIH), a company related through common control. The retail merchandise programs include appliance sales and rentals, appliance service work and merchandise financing. The Company continues to provide certain administrative services to UEIH relating to the retail merchandise programs.

The proceeds on the sale comprised $342 million of cash and $150 million of UEIH 5.2% cumulative redeemable preferred shares. The cash received was applied to reduce short-term borrowings and pay a dividend on common shares of $135 million.

This related party transaction has been accounted for at the carrying amounts of the net assets transferred, resulting in a $38 million charge to the Company's retained earnings. The charge to retained earnings represents the unrecorded deferred income taxes on assets sold of $31 million and adjustments and costs of disposition of $7 million. The unrecorded deferred income taxes arose through the use of the flow through tax accounting methodology.

The following is a summary of the net assets transferred as part of the transaction:

| | *($millions)* |
|---|---|
| Accounts receivable and other current assets | 71 |
| Finance contracts and other assets | 107 |
| Rental equipment and other capital assets | 410 |
| | 588 |
| Deferred income taxes - recorded | (65) |
| - unrecorded | (31) |
| Proceeds | 492 |

The reduction in the Company's utility rate base approximates the proceeds received from the sale of assets.

## 16. Related Party Transactions

a. The Company purchases natural gas and transportation services at prevailing market prices and under normal trade terms from commonly controlled companies. During the year ended December 31, 2000, these purchases totalled $45 million (1999-$36 million). The Company also provides storage and transportation services to commonly controlled companies under normal trade terms. During the year, this revenue totalled $7 million (1999-$4 million).

b. The Company provided administrative, management and other services to commonly controlled companies totalling $6 million (1999-$7 million), which were recovered at cost. Charges from related parties for administrative and other goods and services were $11 million (1999-$11 million) as approved by the OEB. The Company received dividends from the UEIH cumulative redeemable preferred shares of $8 million (1999-$8 million).

c. At December 31, 2000, the Company has intercompany receivable balances of $4 million (1999-$10 million) and intercompany payable balances of $1 million (1999-$2 million), which are recorded in accounts receivable and accounts payable respectively.

d. In December 2000, UEI and UEIH completed a corporate reorganization. Both UEI and UEIH are companies related to the Company through common control. The corporate reorganization transferred all of the assets and liabilities of UEI to another company controlled by UEIH. The only remaining asset of UEI was a deferred income tax asset associated with losses from prior years, which can be applied to future years' income tax liabilities. Subsequent to the reorganization, the Company purchased all the outstanding shares of UEI from UEIH, in exchange for 100,000 Class C, Series 1 redeemable preference shares of the Company. The transaction has been recorded at $18 million, which is equal to the redemption value of the preference shares and the book value of the deferred income tax asset.

## 17. Contingencies

The Company, in the course of its operations, is subject to environmental and other claims, lawsuits and contingencies. Accruals are made in instances where it is probable that liabilities will be incurred and where such liabilities can be reasonably estimated. Although it is possible that liabilities may be incurred in instances for which no accruals have been made, the Company has no reason to believe that the ultimate outcome of these matters would have a significant impact on its financial position.

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Ex. A / Tab 1 / Page 18

Preamble:

Union stated that:

> The US GAAP standard for reporting on pensions is *ASC 715 Compensation – Retirement Benefits* and results in a different pension expense than Canadian GAAP standard (CICA 3461 *Employee Future Benefits*) currently used by Union.

a) Union indicated that there will be an ongoing difference of pension expense between the use of CGAAP and US GAAP. Please outline the different accounting treatments and the reasons for these differences by breaking down the following components of the pension expense under CGAAP and US GAAP:

| | **Accounting Treatment under CGAAP and adopted by Union** | **Accounting Treatment under US GAAP and will be adopted by Union** | **Different? (Y/N)** | **The reasons why it is different** | **Estimate the quantification of the differences ($)** |
|---|---|---|---|---|---|
| **Current Service Costs** | | | | | |
| **Interest Costs** | | | | | |
| **Expected Return on Assets** | | | | | |
| **Amortization of Past Service Costs** | | | | | |
| **Amortization of Actuarial gains/losses** | | | | | |
| **Amortization of Transitional Obligation** | | | | | |
| **Total Pension Expense** | | | | | |

The components of the pension expense list above could change depending on Union's accounting policy choices. As a result, please revise the components as needed in responding to this question.

b) Please evaluate the impacts on Union's rates due to the differences identified above.

---

**Response:**

a) Please see the response at Exhibit B1.5 a) v).

b) There will be no impact on Union's rates due to the change in accounting for employee future benefits until rates are rebased under US GAAP as proposed for 2013. In 2012, Union will be reporting using US GAAP but proposes amortizing the regulatory asset into an expense to arrive at the employee future benefit expense that would have been recognized under Canadian GAAP.

UNION GAS LIMITED

Answer to Interrogatory from
Building Owners and Managers Association Toronto ("BOMA")

a) Why is Union Gas Limited changing its accounting standards for financial statements to US GAAP, beginning on January 1, 2012? Please discuss fully. Are there advantages to Union's Canadian ratepayers from such a change? Please discuss.

b) Is Union seeking Board approval in this case to transition its "accounting and reporting standards" to US GAAP, or does it already have such approval from the Board to do so, or does it not think it requires Board approval to do so? Please explain fully.

c) i) Does US GAAP result in larger or smaller annual pension expenses for Union for financial reporting purposes, and/or for Canadian regulatory purposes, than Canadian GAAP? Everything else being held equal, will it result in higher rates?

ii) Are the pension expenses part of O&M costs, or other costs, that are currently, and historically, included in Union's cost of service, under OEB regulatory rules, including accounting rules? Please provide an example showing how pension expenses are now reported for regulatory purposes.

d) i) Please explain why a change in measurement date from September 30 to December 31 results in a change to Union's retained earnings; use a numerical example to demonstrate, if necessary.

ii) Lines 18-19, p. 18. The charge to earnings on transition is stated to result "due to amounts that would have been previously recognized through pension expense had Union been reporting in US GAAP historically".
Please explain why there is a charge to earnings due to difference in the amounts claimed as "pension expenses" going forward under US GAAP vs. Canadian GAAP. Does this mean the expenses under US GAAP would have been larger?

iii) Over what period of time is the differential between pension expenses as reported under US GAAP and Canadian GAAP aggregated to establish the amount of the charge to retained earnings? What is the authority for such a calculation, which is retroactive in nature?

e) Is the charge to "retained earnings", mentioned at line 18, based upon the amount of pension expenses which Union needs to record in its regulatory accounts for 2012? Please explain fully.

f) Please explain why Union should not defer this complex issue to next year's rebasing proceeding. Please explain why Union believes it needs some form of protection from the effects of this change in 2012.

g) Please describe what pension expenses are, and how they are calculated, providing all assumptions, with reference to both Canadian and US GAAP, for both financial reporting purposes and Canadian regulatory purposes.

h) Please provide any accounting memoranda, or other documents that provide a more detailed discussion on the issues raised in a) through g) above, and all related issues, including the reasons for the switch from Canadian GAAP to US GAAP, for Canadian financial reporting purposes and Canadian regulatory purposes to US GAAP, whether these memoranda are from Union Gas Limited or any company which owns, directly or indirectly, the shares of Union Gas L.P., including the ultimate parent company, or third parties retained by any of these entities.

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**Response:**

a) Please see the response at Exhibit B1.5 for Union's application to the Ontario Securities Commission for exemption from IFRS. Please see the response at Exhibit B1.5 a), v) for the discussion of the change.

b) No. Union has obtained the approval of the Canadian Securities regulator to prepare and file financial statements in US GAAP. Union will request Board approval to set rates based on US GAAP in its' rebasing application.

c) i) Union's net benefit cost under US GAAP is lower than Canadian GAAP. All other things being equal, rates based on US GAAP will be lower.

   ii) The net periodic benefit cost is included benefits in O&M for accounting, reporting and regulatory. There is no difference between accounting for regulatory reporting and financial reporting.

d) Please see the response at Exhibit B1.5 a), v).

e) Please see the response at Exhibit B1.5 a), v).

f) Please see the response at Exhibit B1.5 a), v).

g) This information will be provided in Union's rebasing application in order to set rates based on US GAAP.

h) Please see the response at Exhibit B1.5.

UNION GAS LIMITED

Answer to Interrogatory from
Canadian Manufacturers & Exporters ("CME")

Reference: Exhibit A, Tab 1, pp.18 and 19

Please explain how Union's decision to transition to US GAAP in 2012 is a matter beyond Union's control.

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**Response:**

Union's request for a deferral account to capture the impact of the conversion to US GAAP is not considered to be a Z Factor Adjustment under the Incentive Regulation Mechanism. This request is consistent with the Board's findings in EB-2008-0408 in the Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment. Similar to the transition to IFRS, the conversion to US GAAP results in an adjustment to opening retained earnings for Future Employee Benefits. Union is proposing to capture this adjustment as a regulatory asset (deferral account) to and to amortize these costs to expense the Canadian GAAP equivalent to align with how rates are set. Disposition of any balance in the deferral account will be triggered when rates are rebased under US GAAP.

The requirement to transition from Canadian GAAP is beyond Union's control. It was management's decision to pursue the conversion to US GAAP as an alternative to IFRS.

UNION GAS LIMITED

Answer to Interrogatory from
Canadian Manufacturers & Exporters ("CME")

Reference: Exhibit A, Tab 1, pp.18 and 19

Assume that the Board defers its consideration of Union's request for this deferral account to Union's Rebasing Application. What is the estimated amount of the retained earnings debit for 2012 for which Union is seeking deferral account protection?

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**Response:**

The amounts to be captured in the proposed deferral account are currently being recovered from customers in approved rates. The recognition of a deferred receivable for these costs will allow Union to amortize these costs to increase the US GAAP expense to the Canadian GAAP equivalent. The alternative to the deferral account would be an adjustment to utility earnings for the purposes of the earnings sharing calculation to increase the expense to the Canadian GAAP equivalent for regulatory reporting. The deferral account treatment keeps the adjustment in both the results reported in the general purpose financial statements and regulatory filings. At this time, Union is unable to predict the final total amount of the deferral account protection to be requested. The final amount can be calculated following December 31, 2011 when the discount rate is known for US GAAP purposes. The expected amount is estimated to be $7.3 million plus/minus an adjustment for the change in measurement date effect for 2012.

UNION GAS LIMITED

Answer to Interrogatory from
London Property Management Association ("LPMA")

Ref: Exhibit A, Tab 1, pages 18-19

a) What is the expected or forecasted difference in the pension expense between USGAAP and CGAAP for 2012?

b) The evidence indicates that Union has reported using the USGAAP standard to its parent company. Please provide the difference in USGAAP and CGAAP based costs for each of the last 3 historical years.

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**Response:**

a) The actual US GAAP pension expense for 2012 cannot be calculated until after December 31, 2011. The forecasted difference in pension expense for 2012 is as follows:

| | Canadian GAAP | | US GAAP | | Difference | |
|---|---|---|---|---|---|---|
| | Pension | Other | Pension | Other | Pension | Other |
| 2012 | 26,487 | 8,026 | 23,651 | 6,427 | 2,836 | 1,599 |

b)

| | Canadian GAAP | | US GAAP | | Difference | |
|---|---|---|---|---|---|---|
| | Pension | Other | Pension | Other | Pension | Other |
| 2010 | 27,543 | 7,168 | 27,482 | 5,372 | 61 | 1,796 |
| 2009 | 16,527 | 5,706 | 12,445 | 3,882 | 4,082 | 1,824 |
| 2008 | 14,486 | 5,501 | 12,821 | 3,786 | 1,665 | 1,715 |

UNION GAS LIMITED

Answer to Interrogatory from
School Energy Coalition ("SEC")

Please provide a copy of the Board order permitting the Applicant to move to US GAAP effective January 1, 2012. If there is no Board order, please provide a copy of the Applicant's application for an order so permitting, or a reference to the relevant EB#.

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**Response:**

Union will apply to move to US GAAP in its 2013 rebasing application.