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## **Summary: Gaz Metro Inc.**

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Credit Rating:  
A-/Stable/--

### **Rationale**

The ratings on Gaz Metro Inc. and its subsidiary, Gaz Metro Limited Partnership, (GMLP) reflect the stable nature of its regulated gas distribution business, with strong cash flows and consistent financial performance. The ratings also consider the modest benefits of diversification achieved through the GMLP's regulated transportation interests, which include a 50% stake in Trans Quebec & Maritime Pipeline Inc. (TQM), and a 26.9% interest in Portland Natural Gas Transmission System (PNGTS). The key challenges facing GMLP in the Province of Quebec are low market penetration due to competitive electricity pricing, exposure to economic slowdowns, and high gas prices relative to oil.

GMLP is a Montreal-based, regulated, gas distribution and transportation company. Regulated gas distribution represents 78% of assets (C\$2.3 billion) and 92% of earnings (C\$153.3 million). The Quebec distribution company represents the bulk of the gas distributions earnings (GMLP also owns a small U.S. gas utility, Vermont Gas Systems Inc.). The Quebec utility operates under performance-based regulatory arrangement where most operating costs are passed through to customers. The utility earns its return for delivery of the natural gas and has no commodity exposure, as gas costs are completely passed through to consumers. GMLP is allowed to generate incentive earnings above the regulated return on equity of 10.96%. GMLP can also recoup exogenous costs associated with increased gas prices; increased interest, storage, and transportation costs; and weather variations through regulated deferral accounts.

GMLP distributes 97% of natural gas consumed in the province of Quebec; however, market penetration of natural gas in Quebec is low, about one-half the national average. Approximately 39% of the partnership's Quebec-based gross revenues are derived from industrial companies, 42% from commercial customers, and 19% from residential customers. GMLP has a low residential penetration rate, due to highly competitive electricity prices provided by the government-owned monopoly Hydro Quebec. GMLP enjoys a tenuous price advantage over electricity in the commercial market as long as average gas prices remain below C\$6.00 per gigajoule. As Hydro Quebec is likely to propose rate increases after the current electricity rate freeze ends April 30, 2004, some of the competitive pressure associated with rising gas prices could be alleviated.

Gaz Metro's high exposure to industrial customers with fuel-switching capability exposes GMLP to the pricing differentials between natural gas and fuel oil prices. As well, the large exposure to industrial customers exposes GMLP to economic slowdowns. The provincial economy is somewhat cyclical, given the large manufacturing sector, but the cyclical nature has been diminishing over time as the service sectors' share of output has grown. The main risks to Quebec's economy remain the economic health of the U.S. and of the other Canadian provinces, given the importance of the trade sector to Quebec.

GMLP's above-average financial risk profile reflects the supportive gas

distribution regulatory agreement, and profitable gas transportation operations that contribute slightly less than 15% of cash flows. Total debt to capital is about 60% and should remain stable due to regulatory constraints and trust indentures. Cash flow protection measures are good with funds from operations (FFO) interest cover of 4.9x and FFO to total debt of about 28%. The strong cash flow generation is more than sufficient to meet all required capital expenditures, and the partnership is required to distribute all of its earnings to unitholders.

#### **Liquidity.**

The liquidity is adequate. At Dec 31, 2003 the company had about C\$158.5 million outstanding on its C\$300 million CP program, which is adequate given normal seasonal fluctuations that are consistent with building gas inventories in the fall to meet winter requirements. The CP program is backed by a C\$300 million term loan that matures in April 2005. GMLP and its subsidiaries also have about C\$180 million in revolving short-term lines of credit, most of which are available.

The maturity schedule is not onerous with C\$16.7 million due in 2004. The C\$300 million bank facility matures in 2005 but will likely be renewed.

#### **Outlook**

The stable outlook reflects the expectation of a steady regulatory regime and consistent earnings. Gaz Metro's financial risk profile is expected to remain relatively unchanged in the near term, as the company's cash flow protection measures will be largely determined by its deemed capital structure and regulated returns.

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